Politics not quite as usual
Views on the intersection of politics and markets
Investors have mostly shrugged off a series of political upsets – from Brexit to U.S. President Donald Trump's surprise election win. Yet these developments have long-term consequences. There are fundamental questions about the future of the European Union (EU) and how to address the complex root causes of populism and nationalism. An increasingly transactional U.S. approach to foreign affairs, waning support for free trade and uncertain prospects for U.S. tax reform also have big and differentiated implications for economies, sectors and companies.

These topics are the subject of vigorous debate among BlackRock portfolio managers and strategists. We do not have all the answers, but here we present some of our thinking, including Q&As with our experts.

Summary

We see diminished political risks in the short run in Europe, and potential for some growth-enhancing reforms in major economies around the world. Some of this good news is already priced in, but we expect a steady and synchronized global economic expansion to underpin risk assets for now.

Longer term, we see significant risk of populist policies that would hurt business, such as restrictions on trade and immigration. A starkly more transactional U.S. approach to foreign affairs challenges long-standing security and trade pacts, and we see North Korea’s nuclear ambitions as the top security threat.

We see fading prospects for comprehensive U.S. tax reform amid legislative gridlock and distracting probes into ties between White House officials and Russia. Yet depressed expectations lower the bar for positive surprises, and we see regulatory easing as an underappreciated force in business and markets.

Europe may have its best opportunity in decades to push through reforms that make the EU more sustainable and effective. These are much needed to deal with rising populism and any economic deterioration. Potential flare-ups are Italy’s fractious politics and a possible “no deal” on UK Brexit talks.
The big picture

We see political risk receding for now, returning attention to a steady global expansion. Yet ongoing discontent could lead to policy responses that pose longer-term threats to markets.

A series of populist surprises has riveted investors. The political shocks of 2016 – the UK’s Brexit vote and the election of U.S. President Donald Trump – signaled a dissatisfaction with the status quo, particularly among baby boomers who make up an increasing share of electorates. Rising inequality in some countries and a perceived loss of sovereignty in others also play a part.

Economic issues such as the state of the economy, unemployment and public finances dominated in the years following the global financial crisis and European sovereign debt woes. Terrorism and immigration have leapt to the top of voter concerns since 2014. See the Shifting worries chart. Similar trends are driving populist politics in many countries.

Markets have proved resilient to political shocks to date, recovering swiftly after initial selloffs. Investor caution leading up to these events may be part of the story. A benign reflationary backdrop and improving corporate earnings around the world also help.

A political cloud seems to be lifting in Europe after the French election delivered its most pro-European president in decades. And German chancellor Angela Merkel looks set to win a fourth term in September. This could open a window of opportunity for Europe’s two largest economies to cooperate in promoting reforms vital to the eurozone’s sustainability. See pages 12-15 for details. There are risks. Italian elections could result in fragile coalitions, and raise questions about Italy’s commitment to the euro. And there is a risk that the UK cannot reach a deal with the EU before exiting in 2019.

In the U.S., the legislative agenda has slowed amid investigations of potential Russian election interference and other distractions. A fractious Republican caucus with only a slim Senate majority leaves the party leadership with little margin of error in approving legislation. And relations between the two major parties are as fraught as ever.

The Republican policy agenda could be derailed if the party loses control of either chamber of Congress in the 2018 mid-term elections. A challenge is fulfilling the promises Trump made during his campaign, which attracted disproportionate support from older white males, many in the so-called rust belt states. Stagnant wage growth for the middle class, sharply rising health insurance premiums and an epidemic of opioid addiction are among the issues requiring policy responses.

Our bottom line: If current governments fail to implement policies that improve the plight of disenfranchised and disgruntled voters, we could see more populist election victories in the years ahead. We believe this could lead to a further backlash against the free flow of people and goods across borders, threatening global supply chains and economic growth. The longer governments wait to address voter concerns, the greater the chance of eventual policy overreach that could hurt markets.
Room to run

Political events have the potential to sway markets, but we believe investors also need to look through short-term noise and focus on the big picture: underlying economic and market trends. The outlook is pretty bright in this regard, in our view. The U.S. economic recovery from the financial crisis has been slow and grinding, and some worry that it may be on its last legs. We believe it has room to run. The slower the pace of a recovery, the longer it takes to absorb the economic slack created in the last recession — and the longer it takes to reach full capacity and ultimately the peak that signals the cycle’s end. See our Global macro outlook of May 2017 for details.

The Are we there yet? chart shows U.S. economic cycles since 1953, with each dot on a line depicting a calendar quarter. What stands out when time is replaced by economic progress? The current cycle (the orange line) looks normal — and is closely tracking the previous two cycles of 1990-2001 and 2001-2007 (blue and green).

Estimates of economic slack are imprecise. Yet even if there is no slack left, as some labor market indicators suggest, the economy’s anemic pace of growth implies there are years — not quarters — to go in the current cycle, in our view.

Are we there yet?
Comparison of U.S. economic cycles, 1953-2016

European optimism

Investors have long been downbeat on the eurozone’s growth prospects. The market is pricing in GDP growth of just 1.2% in its big-four economies in the year ahead, based on our analysis of bond and equity valuations. See the European signs of life chart. The market-implied growth rate has rebounded sharply in recent months, but still lags the forward view of the BlackRock GPS, which combines traditional economic indicators with big data signals such as Internet searches. The unusual divergence between our GPS and marked-implied growth rates since 2015 can be explained by political risks: most recently, jitters ahead of the French presidential election.

We see further room for market-implied GDP rates to play catch-up with our GPS in the coming quarters as political uncertainty lifts. We see this pushing European equities and bond yields higher, reflected in our overweight view on European equities and an underweight view on European sovereign debt and credit. What are the risks? Nominal income growth is still sluggish and needs to pick up as tail winds from lower oil prices and a weaker currency fade. Also, Europe has greater exposure to China and emerging markets than the U.S., and could be disproportionately impacted by any stall in economic momentum there.
All regions of the world economy are experiencing a synchronized upturn in 2017 for the first time in several years. The global reflationary dynamic is reflected in a pickup in global trade volumes. Growth in the dollar value of trade has rebounded sharply after contracting for much of the past two years. This is a sign of health in the global economy. See the Budding trade recovery chart.

The volume of world merchandise trade has tended to grow about 1.5 times faster than world output since 1981, but the ratio has slowed to 1:1 since the financial crisis, according to a World Trade Organization (WTO) April 2017 report. This partly reflects weak investment in much of the world. Structural changes such as China’s rebalancing away from investment and toward consumption are another potential dampener in coming years.

Any rise in protectionism could pose a threat to the nascent global trade recovery. We do not see risks of a significant increase in actual protectionist measures this year. Increased U.S. pressure on China and other countries to open up their markets may actually yield benefits. Yet escalating protectionist rhetoric and a more transactional U.S. approach to trade that favors bilateral over multilateral deals is a longer-term concern. See page 7 for details.

What, me worry?
Fund manager top ‘tail risks’ and global equities, 2015-2017

Markets have climbed a wall of worry in the past few years. What are investors most worried about in the world today? The top tail risk cited by investors was dominated by economic concerns from late 2015 through early 2016, mostly around fears of China dragging the world into recession, the Bank of America Merrill Lynch Fund Manager Survey shows. See the What, me worry? chart.

Political concerns and uncertainty then jumped into the spotlight, with investors’ minds dominated by Brexit, Trump’s surprise election victory and sporadic worries about EU disintegration. We see concerns about EU cohesion receding until the run-up to Italian elections, which could occur as early as September. See page 12.

China credit risks became the top investor worry in early 2017 as the country tapped its foot on the brakes of credit creation. The lesson from recent history is that fundamentals have mattered much more than politics. Markets have shrugged off most of the top political risks, with bouts of volatility treated as buying opportunities.

The question is when and where politics may start to impact the favorable fundamentals. For example, we could see a failure of the UK to reach an exit deal with the EU hurting its economy and markets. See page 15.
Geopolitics

We highlight key events, trends and risks to watch in 2017 and beyond.

The coming year brings a mosaic of elections, monetary policy decisions and geopolitical hot spots. See the map below. Washington lawmakers face a shrinking window of opportunity to implement tax reform (pages 8-10). Populists have been beaten back in Europe for now, and our attention has turned to trouble brewing in Italy (page 12), improving the workings of the EU (page 13-14) and the shape and outcome of Brexit negotiations (page 15).

The backdrop of synchronized global growth puts central banks at a crossroads. We see the European Central Bank (ECB) debating how much longer its extraordinary amount of monetary support is needed – and how to communicate any changes. The Fed is contemplating how to trim its balance sheet. We see the risks as contained, as we expect central banks to move cautiously and gradually.

China’s growth momentum has slowed as authorities are cracking down on credit excesses. These measures and other structural reforms are crucial to put the economy on a sustainable long-term path, but bring short-term risks. Accidents can happen when liquidity is tightened in economies addicted to credit. We see the upcoming 19th National Congress of the Communist Party as a harbinger for both reform momentum and China’s ambitions on the world stage. See China’s tricky transition of February 2017.

Mexican elections loom large on the EM political calendar. We see rising risks of a populist outcome, partly reflecting the U.S. administration’s anti-Mexican rhetoric. Brazil’s government is in crisis, and early elections are a possibility. Geopolitical hot spots abound, with North Korea representing the most immediate threat (page 7).

Mark your calendar

Events and geopolitical risks to watch in 2017 and beyond

Source: BlackRock Investment Institute, May 2017.
Former U.S. National Security Advisor Tom Donilon gives investors a geopolitical tour.

What’s the current state of geopolitics?
First, there is significant uncertainty about the direction and tone of U.S. national security policy. Second, the great power relationships are evolving and becoming more competitive. Third, there is an unusual number of volatile and unstable situations. These include North Korea’s nuclear and missile drive, failed states and the resulting effects on migration and terrorism, Russia’s confrontation with the West, populist pressures in Europe and increasing cyber threats.

These are grim prospects …
There are near-term positives for investors. The French election took an existential threat to the European project off the table for now — and I don’t see a rejection of Europe in the upcoming German elections. U.S.-China relations have been constructive; a trade war is unlikely this year.

Let’s return to your first point: Washington’s agenda.
The Trump campaign challenged the pillars of the U.S.-led post-WWII order, including the value of international alliances, trade and institutions. An experienced national security team has since had some moderating effect, and some campaign slogans have run into the realities of governing. Several characteristics of a new U.S. approach to foreign affairs have emerged: First, policy is highly transactional and focused on immediate results. Second, the president embraces unpredictability as an operating style. Both have the benefits of flexibility but can call into question the U.S.’s reliability as a long-term partner — and unnerve allies and investors alike. Third, there is a persistent focus on bilateral economic relations, especially trade deficits, which are seen as a zero-sum game.

How does this play into the great power relationships?
The principal development is that Russia has turned away from integration with the West to challenging it, from Ukraine and probing NATO’s borders to Syria and alleged interference in Western elections. I don’t see U.S.-Russia relations improving any time soon. Many administration policymakers see Russia as a significant security threat, and there are multiple inquiries into election meddling.

How about the upstart superpower, China?
China’s leaders appear confident and eager to fill any leadership vacuum after the U.S. announced its withdrawal from the Paris climate accord and pulled out of the Trans-Pacific Partnership trade agreement. President Xi Jinping is set to put in place his team and policy agenda for the next five years at the 19th National Party Congress this fall. Until then, I see Xi seeking to maintain economic growth while trying to rein in financial excesses, avoid a direct confrontation with the U.S. and assert international leadership in trade and climate. Next year presents challenges for U.S.-China relations, especially on North Korea and bilateral trade.

Which area of instability worries you most?
North Korea represents the most significant security challenge. Attempts to put it on a non-nuclear path have failed, and all indicators are negative: nuclear tests and increasingly capable missile technology. It represents both a direct nuclear and proliferation threat. The approach so far has been to push China to pressure North Korea to denuclearize. It is unclear whether China is able or willing to do so, making this issue a key source of tension in U.S.-China relations. I expect more North Korean provocations and continuing risk of escalation — but see military options as very difficult given South Korea’s vulnerability.

How explosive is the Middle East?
The administration has made a top priority of forging an alliance with the Gulf states against ISIS and Iran, an initiative well-received in the Gulf. I see the U.S. adopting a more confrontational stance toward Iran, but expect the nuclear deal to hold. Saudi Arabia’s ambitious economic and cultural transformation is pressured by low oil prices, but we don’t expect political instability. ISIS is being pushed out of its territory in Iraq and Syria, increasing the risk of more terror attacks in Europe.

What risk is below investors’ radar screens?
The volume, sophistication and sources of cyberattacks are increasing significantly — and the world has very uneven defenses. More interconnectivity thanks to an explosion in internet-of-things devices — with little regard to security — will make us even more vulnerable.
The prospects for U.S. tax reform and infrastructure spending are fading, but we see an underappreciated shift toward more flexible regulation that could help business.

Media headlines paint a picture of political disarray in Washington. Yet a closer look tells a more nuanced story, we believe. First, a system of checks and balances and strong institutions blunt the sharper edges of any new president’s agenda. Second, the administration has appointed steady and experienced hands in key posts such as national security and defense. Lastly, the private sector is humming along regardless of dramatic political headlines, with a corporate earnings recovery in full swing.

Some of the froth has come off of the so-called Trump trade. Shares of companies that performed best after the election such as banks have given up some of those gains, while initial losers such as tech have recouped relative losses. See the Trump trade fizzes chart. Other legs of the Trump trade have fully reversed, with the Mexican peso – a barometer of anxiety about a tougher U.S. stance on trade – recovering from its post-election losses.

The U.S. faces long-term fiscal challenges. Health care and Social Security make up roughly half of federal spending today, and this share is set to grow over the coming decades as the population ages. Absent any changes, this will lead to a steady rise in the deficit and debt levels over time. See the Budget breakdown chart. These dynamics leave the U.S. with little fiscal wiggle room. This is why most plans to reform the tax system typically aim for budget neutrality over the long term, after accounting for any growth-boosting effects. Unfunded tax cuts could worsen an already poor fiscal trajectory.

Congress also has yet to draft a budget for fiscal 2018, which starts Oct. 1. Controversial aspects of Trump’s agenda, such as funding a border wall and cutting social programs, are sticking points. Another short-term deal to fund the government may be needed if Congress cannot agree on a budget. A battle also looms over raising the U.S. debt ceiling. The second half of 2017 could be bumpy.
Legislative clock is ticking

Many Republicans see this as a once-in-a-generation opportunity to rewrite an overly complex and onerous tax code. On their menu: big cuts to the U.S. corporate tax rate, a one-off “deemed repatriation tax” on the roughly $2.5 trillion of corporate cash held overseas, lowered tax rates on investment income, and a cut in the top personal tax rate. The goal is to stimulate investment and consumption, and thereby boost growth.

A troubled attempt to repeal and replace “Obamacare” health legislation and controversy over Russia’s alleged interference in the 2016 election – now being investigated by a special counsel – add to the risk of legislative delays. This could play out in two ways:

Positive: The investigation activates Congress to focus more on tax reform – a key measure of legislative progress ahead of 2018 midterm elections. The White House shows leadership on policy priorities, and Congress passes tax reform legislation early in the new year.

Negative: A distracted White House fails to clarify policy priorities, and the Russia scandal deepens. Congressional Republicans start to distance themselves from the Trump administration. The reform agenda is derailed.

Tax: It’s all in the details

We see three scenarios for U.S. tax reform: major reforms including a sharp reduction in the corporate tax rate; a scenario whereby reforms are watered down and the budget deficit rises; and an outcome in which tax reform is delayed indefinitely. See the Taxing challenge table below.

Our comprehensive reform scenario would be budget-neutral over time. It would be stimulative in the near term, but with a payback in later years as loopholes and deductions are limited. This would benefit global equities and lead to rising interest rates. The modest tax cuts scenario, which we see as the most likely outcome, would have a similar market impact in the short run. It would result in an economic stimulus – but with the likely cost of higher budget deficits and inflation. Our derailment scenario is partly priced in as expectations for tax reform are low, we believe, but still could hurt risk assets in the near term.

We see any market fallout as nuanced. Take the credit markets. The removal of interest deductibility would likely reduce new issuance, benefiting investment grade credits. But this impact could be offset by any stimulus that leads to rising rates. And we see more leveraged credits faring worst from losing the ability to deduct interest expense.

A taxing challenge

BlackRock Market-Driven Scenarios on potential impact of U.S. tax reform, May 2017

<table>
<thead>
<tr>
<th></th>
<th>Comprehensive reform</th>
<th>Modest tax cuts</th>
<th>Derailment</th>
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<tbody>
<tr>
<td><strong>Description</strong></td>
<td>Comprehensive reform, including a large cut in the corporate rate, and the closing of many personal and corporate deductions to make the plan roughly revenue-neutral.</td>
<td>Moderate tax cuts are only partially offset with caps on deductions, leading to larger budget deficits and rising inflation.</td>
<td>Congressional gridlock derails tax reform and even modest attempts at tax cuts.</td>
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| **Key ingredients**  | • Tax cuts are permanent. Deep corporate tax cut, with lower income tax rates, offset with removal of most deductions.  
                       • One-off deemed repatriation tax on overseas corporate cash.  
                       • End of corporate interest deductibility; immediate capex expensing. | • Tax cuts mostly expire after a decade; watered-down elements of the comprehensive scenario.  
                       • Lower corporate and personal tax rates; caps on deductions.  
                       • But the stimulus generates some positive investor sentiment. | • Trump administration introduces piecemeal plans to cut corporate and personal taxes.  
                       • Proposals fail to gain traction ahead of 2018 midterm elections. |
| **Global equities**  | Highly taxed U.S. domestic companies outperform. | Personal income tax cuts support consumer stocks. | Post-election gains in value stocks are further eroded. |
| **U.S. credit**      | Investment grade (IG) spreads tighten; highly leveraged names underperform. | IG spreads tighten; highly leveraged names underperform. | Spreads widen in flight to quality. |
| **Government debt**  | U.S. Treasury yields rise and the yield curve steepens. | Treasury yields rise on the back of rising deficits; yield curve steepens. | Treasuries rally on lower growth expectations. |

Sources: BlackRock Investment Institute and BlackRock’s Risk and Quantitative Analysis group.
Loopholes and deductions
Comprehensive tax reform has eluded both major political parties since the mid-1980s. The ingredients are simple: Cut marginal tax rates, while reducing loopholes and deductions to offset the budget impact. Cutting taxes alone runs the risk of creating a big hole in the deficit. Example: Each percentage point cut in the 35% corporate rate leads to $100 billion in lost tax revenue over a decade, the Joint Committee on Taxation estimates. Many potential offsets such as cutting popular deductions are politically off limits. What’s on the table this time?

Deemed repatriation tax: A one-off tax on corporate profits held abroad – applied regardless of whether companies bring the cash back. The proceeds could be set aside to finance other policy priorities such as infrastructure expenditure, making it potentially appealing to both Republicans and Democrats.

Interest deduction and capex expensing: Tax reformers propose allowing companies to immediately deduct the cost of capital expenditures from their income, rather than depreciating it over time. This is meant to encourage investment. It would be offset by capping the interest deduction, which lets companies deduct net interest payments on debt from their taxes. This would reduce incentives to leverage up and level the tax playing field with dividend payouts. It would make it less attractive to issue debt and use the proceeds to buy back shares.

Border adjustment: House Republican leaders have proposed a border adjustment tax (BAT) to pay for deeper corporate tax cuts, increase U.S. competitiveness and reduce incentives to offshore production and profits. The BAT would effectively subject imports to a 20% tax, while exempting exports. Supporters argue the BAT’s impact would be offset by a 25% rise in the dollar, leaving no net impact on trade balances or consumer prices. Opponents say the BAT risks retaliation by other countries and is hard to apply to financial services. We believe currency movements are driven by many factors beyond any BAT. An imperfect dollar adjustment would hurt importers.

We see little chance of the BAT being implemented as proposed, given opposition in the Senate and White House. We may see a move toward a territorial tax system.

Munis mull tax reform
U.S. municipal bond implied tax benefit, 2016-2017

Sources: BlackRock Investment Institute and Bloomberg Barclays, May 2017.
Notes: The market implied tax benefit is a rough measure on how munis are pricing value of their tax-exempt status. It is calculated by subtracting the ratio of the yields on the Bloomberg Barclays Municipal Bond Index and U.S. Aggregate Corporate Index from one.

Muni murmurs
Asset prices have waxed and waned with expectations of U.S. tax reform. Municipal bonds are a case in point. Any large cut to the top personal marginal tax rate would diminish the value of their tax-exempt status.

Munis used to trade with a market-implied tax benefit of just over 40%, in line with the top personal marginal tax rate. This figure slumped to 17% when expectations for comprehensive tax reform peaked just after the U.S. election, and has now recovered to almost 30%. See the Munis mull tax reform chart. We see room for further gains in this metric – and muni valuations. Our “compromise” scenario sees only modest personal tax cuts being implemented, with the tax exemption for muni income remaining intact. Any introduction of caps on other individual deductions would only boost demand for munis as one of the few remaining tax shelters, we believe.

"Investors should move away from the notion that tax reform will have a big impact on munis – and focus on the income and value the asset class offers."

Peter Hayes — Head of BlackRock’s Municipal Bonds Group
BlackRock co-founder Barbara Novick highlights underappreciated regulatory changes.

What do you see Washington getting done this year?
It is critical to look beyond the legislative efforts of the White House and Congress. We have a lot of independent regulators and agencies, and all have—or will soon have—new heads who are eager to make their mark. As they staff up, I see efforts to rightsize regulation gaining momentum.

Some people talk about this as if the sky is falling: repeal of all rules resulting in polluted waters and banks running amok. That narrative simply does not reflect reality. You have to put it into context: We’ve seen an unprecedented amount of rulemaking during the previous administration. And now policymakers are reviewing and potentially reversing some of it. This is about lightening the regulatory burden by making rules more efficient and tailored.

That’s why I call it rightsizing regulation. It’s important this happens in a thoughtful way. Some regulations had adverse unintended consequences. An easing of regulations needs to be well thought-out to avoid similar problems.

Why should investors care?
A lighter regulatory burden benefits business. This tends to get lost in the noise coming out of Washington—and is an underappreciated market force. Even just a business-friendly or softer interpretation of current regulations can reduce costs substantially.

Barbara Novick
BlackRock Vice Chairman

For example, most people would agree the U.S. needs to replace and upgrade its aging infrastructure. But many projects get stuck in a quagmire of federal, state and local permits, environmental reviews and legal challenges. If you want to attract private capital, you need clear and enforceable rules, streamlined procedures, and a consistent and predictable policy framework. This applies to much more than infrastructure. Knowing the rules creates a positive climate for companies to invest in their business.

Tax reform could help in that respect. Will it happen?
We have an incredibly complicated tax code. It’s a bipartisan goal to have a tax system that is simple, fair and globally competitive. Of course the problem is how you define “fair,” both on the individual and corporate level. Actual tax reform cannot be a complete budget buster, so you’ll need some revenue raisers. This leads you into the winners-and-losers problem that has vexed policymakers on both sides of the aisle. Every exemption or deduction affects a constituency that wants to keep it. Try to take it away, and somebody is going to complain about it—loudly. The bottom line is that tax reform is just really hard and takes a long time to get over the finish line.

Regulatory review
Selected examples of regulation-related U.S. actions and reviews, 2017

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<thead>
<tr>
<th>Industry</th>
<th>Action</th>
<th>Date</th>
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<tr>
<td>Financial</td>
<td>A new fiduciary rule for financial professionals is partially implemented but subject to ongoing review.</td>
<td>May 22</td>
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<td>Financial</td>
<td>Presidential memorandums instruct the U.S. Treasury to review the process for designating financial institutions as “systematically important” and the federal government’s orderly liquidation authority.</td>
<td>April 21</td>
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<tr>
<td>Financial</td>
<td>An executive order directs Treasury secretary and regulators to revise and review Dodd-Frank rules.</td>
<td>Feb. 3</td>
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<td>Health</td>
<td>An executive order authorizes the heads of federal agencies to waive Affordable Care Act rules that impose any fiscal or regulatory burden.</td>
<td>Jan. 20</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>An executive order allows governors and agency heads to request expedited environmental reviews and approvals for infrastructure works.</td>
<td>Jan. 24</td>
</tr>
<tr>
<td>Resources</td>
<td>U.S. announces intent to withdraw from the Paris Agreement on climate change.</td>
<td>June 1</td>
</tr>
<tr>
<td>Resources</td>
<td>The Congressional Review Act is used to revoke the Stream Protection Rule.</td>
<td>Feb. 16</td>
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<tr>
<td>Resources</td>
<td>An executive order advances the construction of the Keystone XL and Dakota Access oil pipelines.</td>
<td>Jan. 24</td>
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<tr>
<td>Telecoms</td>
<td>The Federal Communications Commission (FCC) proposes to roll back 2015 Internet neutrality rules.</td>
<td>May 18</td>
</tr>
<tr>
<td>Telecoms</td>
<td>The FCC loosens a 39% national cap on audience share for TV station owners.</td>
<td>April 20</td>
</tr>
<tr>
<td>Transport</td>
<td>The Environmental Protection Agency announces it will re-examine fuel efficiency standards</td>
<td>March 15</td>
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Source: BlackRock Investment Institute, June 2017.
Europe

Nationalist, anti-immigration parties are not going away, but Europe now has a window of opportunity to reform and consolidate the EU so that it can endure.

Emmanuel Macron went from third place in the polls to a large victory as French president in just four months – all while remaining outside the mainstream parties that have ruled France for decades. He could pave the way for business-friendly reforms, with an immediate focus on loosening the labor market. Even if Macron’s new party falls short of an outright majority in the June parliamentary elections, we believe he will likely be able to work with centrists to pass legislation.

Macron’s victory came after the populist Freedom Party underperformed high expectations in the Dutch elections in March. Importantly, German Chancellor Angela Merkel’s party has built a double-digit lead in the polls ahead of the Sept. 24 federal election. Support for both the pro-EU Social Democrats and populist AFD has faded, and Merkel looks set to win a fourth term in office just as Macron begins his term. Together, Macron and Merkel have the potential to consolidate and revive the European project.

Worrying about Italy

Our bigger concern: Italy. Anti-establishment parties hostile to the euro have total support of about 45%, polls show. The largest is the Five Star Movement, which has promised a referendum on eurozone membership. Polls show Five Star running neck and neck with former Prime Minister Matteo Renzi’s Democratic Party heading into a national election due to be held by May 2018. We believe the election may be held as early as September after major parties agreed on electoral reform in late May.

We see Renzi’s party stitching together another unhappy coalition with a coterie of other parties on the center and left. Forming a stable coalition will be daunting. Changes to Italy’s electoral law have taken the system back to a proportional representation that makes outright majorities hard to achieve. The next coalition is likely to be weak and fragmented, making structural reforms a challenge.

Italy has made limited strides cleaning up bad debts at its troubled banks, including recapitalizing smaller banks and encouraging bigger banks to raise capital. Yet the problem remains sizable and is a brake on growth. The combination of high debt levels, subpar economic growth, political instability and looming ECB policy normalization could lead to a spike in borrowing costs. The path to a rescue package in any crisis would likely be a bumpy one, given that eurozone assistance would be conditional on a stable government able and willing to implement harsh reforms.

We believe Italy’s risks are only partly reflected in the yield spreads of its government bonds versus German bunds. See the Eurozone spreads in context chart. We expect those spreads to widen as the election approaches and could see them blowing out if Five Star wins. The party so far has no allies in Italy’s parliament, but we cannot rule out a coalition of convenience with the Northern League and others. Bottom line: We see potential for an electoral surprise that could rattle risk assets and peripheral bonds.
Delivering reforms
Optimism on Europe’s outlook is building. Investors are seizing on the improving political outlook and upbeat data signaling stronger growth. See the European wakeup call chart. Net equity purchases were a record in the week around the finale of France’s presidential election.

Many eurozone countries are in need of structural reform. As the region’s biggest growth and debt laggards, France and Italy are especially important. We see reforms in both as key to reassuring Germany about the willingness of the EU’s other core members to become more competitive.

Italy’s Renzi initiated some labor market and insolvency reforms, but that drive stalled. The OECD has listed reforms that could lift growth by 6.3% over a decade. These include: reducing regulation and administrative burdens, loosening up the labor market, encouraging more female participation and cutting taxes for low-income earners, it argued in a 2015 report.

Macron’s proposed reforms include increasing labor market flexibility, shrinking the government’s role in the economy, cutting business social security contributions and corporate taxes (the highest in the EU), and reducing regulatory burdens.

European wakeup call
European equity flows and economic activity, 2013-2017

Sources: BlackRock Investment Institute, EPFR and Markit, May 2017.
Notes: The bars show weekly net flows into Western European mutual funds and ETFs. The line shows the eurozone composite purchasing managers’ index (PMI). A number above 50 indicates expansion.

Macron will likely face resistance, with unions fighting attempts to increase flexibility in the implementation of labor laws. Yet he is likely to succeed in pushing at least some reforms through, we believe. Germany could do its part to boost growth and reduce imbalances, such as encouraging stronger wage gains to stimulate consumer spending and launching more public investment. Europe-wide burden sharing or pooling of risk have so far been a much harder sell in Berlin.

Investors have become less worried about eurozone breakup risks, as seen in currency options pricing in the Currency confidence comeback chart. Speculative bets on euro depreciation are the smallest since 2009. Spreads on selected peripheral government bonds such as Italy’s look a bit complacent to us, given the risks reforms won’t be carried out or watered down.

"Sovereign risk premiums for political risks and reform implementation are still not sufficient, especially for Italy."

Scott Thiel – Deputy Chief Investment Officer of BlackRock Global Fundamental Fixed Income

Notes: The chart shows risk reversal for sterling and euro versus the U.S. dollar, based on trading of one-year options. A positive risk reversal means the volatility of calls is greater than the volatility of similar puts. This implies that more market participants are betting on a rise in the currency than on a drop, and vice versa if the risk reversal is negative.
Forged in crises
People only accept change when they are faced with necessity, and only recognize necessity when a crisis is upon them, EU architect Jean Monnet once noted. We see the populist uprising and other strains as both a wake-up call and opportunity for the EU to improve its governance and responsiveness to the economic ills of citizens.

Europe’s recent history of integration is one of big steps taken only when forced by a crisis, as epitomized by the eurozone’s repeated summits and emergency decisions during the debt crisis. This has fortified the region’s ability to respond to countries running into economic and financial troubles. The ECB can intervene in asset markets to limit fragmentation and it now oversees banking regulation. The European Stability Mechanism provides a financial firewall by providing emergency loans to countries in need. That makes the eurozone well equipped to handle crises in all but the largest economies.

Current account deficits have been curtailed, but structural imbalances remain and eurozone economic convergence has stalled or reversed in some cases. Wide North-South differences in fiscal dynamics and economic fundamentals exist, as illustrated by our BlackRock Sovereign Risk Index. See the Not created equal chart.

Europe is now discussing its future shape while trying to manage differences in policy, economic growth and development among its members. Macron has revived debate of a central eurozone budget and the long-taboo subject of fiscal transfers. This would mean countries pooling some revenue and having a eurozone finance minister, with funds used for investments and counter-cyclical spending such as unemployment insurance.

The ambitious proposal has its challenges, including how the democratic oversight would be managed. It also faces deep hostility in parts of the German political world. Berlin has promised to keep an open mind and is open to treaty changes, although these are tough as every country has to ratify them. Dealing with economic migrants and refugees is another big challenge. Recent immigrants need to be integrated into the workforce. For now, a deal with Turkey has helped stem the inflow of new asylum seekers, but any collapse in this arrangement could strain EU solidarity.

Window of opportunity
We believe policymakers now have the best chance for reform in decades. The two largest countries and long-time drivers of integration, Germany and France, are poised to have pro-European, newly legitimized governments. The region’s growth outlook is the brightest since the financial crisis. Dealing with Brexit, migration and the new U.S. administration is pushing the EU toward a united front. Merkel pointedly said Europe must take its fate in its own hands after trans-Atlantic meetings in May.

Pursuing deeper integration could involve a defense union, greater fiscal and tax coordination, and lifting of services barriers. We see progress on the Capital Markets Union and European Banking Union as indications of policymakers’ resolve. Bottom line: We see a window of opportunity for the EU to complete the single market.

“Don’t underestimate the potential for the Macron-Merkel relationship to be a driving force toward reforms and faster EU integration down the line. It could lead to positive surprises for equities.”

Zehrid Osmani – Co-Manager of Pan European portfolios, BlackRock’s Fundamental Active Equity
Bracing for Brexit

The UK faces a big test in negotiating the terms of its exit from the EU. The key risk we see: The UK exits without making a deal or agreeing on an implementation phase by the deadline of March 30, 2019.

Prime Minister Theresa May called a June snap election with the aim to enlarge her Conservative Party’s majority. This should give her government a freer hand to negotiate a smoother Brexit process with the EU and steer a deal through parliament. A narrowing of the polls just ahead of the June election – perhaps partly reflecting the anti-establishment currents running through politics today – threatened this plan. A small majority, one similar to the pre-election balance, would raise the risk that Brexit talks fall hostage to euroskeptics.

Some UK officials scoff at reported EU demands of a €60-100 billion divorce bill, and say that no deal is better than a bad deal. Most of us feel a “no deal” appears unlikely, given the potential economic damage it could cause on both sides. Exporters might suddenly face tariffs and customs checks, for example. Any market fright of a “no deal” outcome would likely send sterling even lower.

Our base case: an outline agreement starting with a two-to three-year implementation phase. We see the UK and EU limiting customs barriers. UK exporters would keep tariff-free access, with some non-tariff barriers in services.

The UK would likely lose its “passporting” ability to sell financial services across the EU. Financial firms are already preparing, and are moving some activity to EU financial centers. We do see a possibility of a negotiated agreement involving close regulatory cooperation and perhaps financial joint-supervision, something the UK Treasury and Bank of England (BoE) have long resisted. And job losses may not be as large as initially feared, with shifts likely to take several years. The range of outcomes is wide.

We see the BoE looking through any short-term Brexit impact unless fears of a “no deal” and a significantly weaker currency drive a sustained inflation surge. The UK jobs market remains strong, with the unemployment rate at four-decade lows. We see the British pound struggling to strengthen beyond $1.30. The BoE is likely to remain accommodative, we believe, given signs of weakness in consumer spending and the clear vulnerabilities Brexit poses to the medium-term outlook.

The former UK Chancellor of the Exchequer shares his thoughts on Brexit negotiations.

How likely is a “no deal” Brexit?
There's a material prospect of no deal. To get a deal that will satisfy the UK government, the House of Commons, EU members and their respective parliaments plus the European Parliament – that’s going to be a major challenge.

It's very easy to see how it would be possible to end up with no deal. One of the stumbling blocks will be determining any transition agreement. Whether it's determining enforcement, the role of the European Court of Justice, the applicability of free movement, it's going to be quite complicated.

If you listen clearly to the EU about a transition period, it does not want a special third regime for the UK and does not want to spend a huge amount of time on this.

What's the middle ground and what would “no deal” mean?
The UK government is going to have to accept some EU conditions. This is a deal that the UK needs more than Europe does. The Europeans are playing quite hard ball knowing the UK needs an interim agreement. It would be pretty bad for the UK to crash out of the EU without any follow-up agreement. The government would do things to minimize the impact. It would still be quite a jolt to not have any trade or security arrangements with our neighbors.

Assuming May leads the negotiations, can she strike a working relationship with Macron and Merkel?
It’s very important. It would help to have the same cast of characters and no major elections in France and Germany over this critical period. These three leaders will need to get to know each other. Some of the recent language has been heated. There should be more constructive dialogue to build trust and less playing to the galleries at home.
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