



Global Investment Outlook

2019



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Richard Turnill
Global Chief
Investment Strategist
BlackRock Investment
Institute

Our 2019 outlook forum brought together roughly 100 investment professionals to discuss the global economic outlook, identify market themes for the new year, debate risks such as recession fears, and refresh our asset views. Our key conclusions:

- **Themes:** We see a slowdown in global growth and corporate earnings in 2019, with the U.S. economy entering a late-cycle phase. We expect the Federal Reserve’s policy to become more data-dependent as it nears a neutral stance, making the possibility of a pause in rate hikes a key source of uncertainty. Rising risks call for carefully balancing risk and reward: exposures to government debt as a portfolio buffer, twinned with high-conviction allocations to assets that offer attractive risk/return prospects.
- **Risks:** Markets are vulnerable to fears that a downturn is near, even as we see the actual risk of a U.S. recession as low in 2019. Still-easy monetary policy, few signs of economic overheating and a lack of elevated financial vulnerabilities point to ongoing economic expansion. Trade frictions and a U.S.-China battle for supremacy in the tech sector loom over markets. We see trade risks more fully reflected in asset prices than a year ago, but expect twists and turns to cause bouts of anxiety. We worry about European political risks in the medium term against a weak growth backdrop. We believe country-specific risks may ebb in the emerging world, and see China easing policy to stabilize its economy.
- **Market views:** We prefer stocks over bonds, but our conviction is tempered. In equities, we like quality: cash flow, sustainable growth and clean balance sheets. The U.S. is a favored region, and we see emerging market (EM) equities offering improved compensation for risk. In fixed income, we have upgraded U.S. government debt as ballast against any late-cycle risk-off events. We prefer short- to medium-term maturities, and are turning more positive on duration. We favor up-in-quality credit. In a total portfolio context, we steer away from areas with limited upside but hefty downside risk, such as European stocks.



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Equities
Oil and currencies
Assets in brief



Elga Bartsch
Head of Economic and Markets Research
BlackRock Investment Institute



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



Kate Moore
Chief Equity Strategist
BlackRock Investment Institute

Setting the scene

We see equities and bonds eking out positive returns in 2019. Global growth looks set to be a key driver of returns as the cycle ages. We see growth moderating, but little near-term risk of a U.S. recession ([pages 4 and 7](#)). Corporate earnings growth is slowing but still decent ([page 13](#)). And bonds are looking more attractive, both as a source of income and as portfolio ballast against any late-cycle growth scares ([page 12](#)).

The end of a decades-long bond bull market means negative stock and bond returns may become more common. We may end 2018 with negative returns in both asset classes – a rare event. See the *Looking for a landing spot* chart. The culprits: uncertainty over trade disputes, late-cycle concerns and tighter financial conditions. Trade frictions still loom but now appear more baked into asset prices. We are wary of European political risks and assets ([page 8](#)). The key risk for equities: Recession fears land us in the chart’s lower-right.

We see potential for a market rebound in 2019, likely with muted returns.

Valuations have cheapened across asset classes, reflecting greater risk as we head into 2019. We still prefer equities over bonds, although with reduced conviction. Risks such as earnings downgrades and market anxiety over a recession are real. This underpins our preference for quality companies with strong balance sheets and sustainable free cash flows. Equity valuations are back in line with post-crisis averages in developed markets – and look particularly attractive in the emerging world. See the *Yielding more* chart. Rising short-term yields are starting to make bonds a viable alternative to riskier assets for U.S.-dollar-funded investors. Two-year U.S. Treasury yields are now more than three times their average over the post-crisis period, as the chart shows. We prefer short maturities but see a role for longer-term debt as a buffer during equity market selloffs. [See page 12](#). We upgrade our view of U.S. government debt on higher yields and their role as portfolio ballast.

Cheaper asset valuations lower the bar for positive performance in 2019, but rising risks argue for caution.

Looking for a landing spot

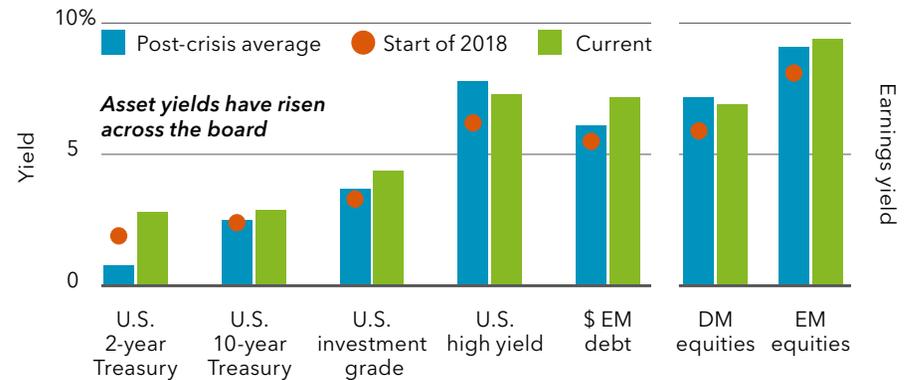
Total annual returns of global stocks and bonds, 1991–2018



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, December 2018. Notes: Global stocks are represented by the MSCI ACWI index. Global bonds are represented by the Bloomberg Barclays Global Aggregate Bond Index. Total returns are shown in U.S. dollars. 2018 returns are through Dec. 6.

Yielding more

Asset yields, December 2018 vs. post-crisis average and start of 2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Thomson Reuters, December 2018. Notes: The post-crisis average is measured from 2009 through 2018. Equity market yields are represented by 12-month forward earnings yields. Indexes used from left to right are: Thomson Reuters Datastream 2-year and 10-year U.S. Government Benchmark Indexes, Bloomberg Barclays U.S. Credit Index, Bloomberg Barclays U.S. High Yield Index, JP Morgan EMBI Global Diversified Index, MSCI World Index and MSCI Emerging Markets Index.

Theme 1: growth slowdown

We expect a slowdown in global growth next year, and see the U.S. economy entering a late-cycle phase. Our *BlackRock Growth GPS* has been trending lower across the U.S. and eurozone, pointing to a slower pace of growth in the 12 months ahead. Growth is ticking up in Japan, but from low levels. See the *Slowing down* chart.

We see U.S. growth stabilizing at a much higher level than other regions, even as the fading effects of domestic fiscal stimulus weigh on year-on-year growth comparisons. This underscores our preference for U.S. assets within the developed world. We expect the Chinese growth slowdown to be mild, as the country appears keenly focused on supporting its economy via fiscal and monetary stimulus. [See page 10.](#)

We see global growth declining, with the U.S. outperforming its developed market peers and China stabilizing.

Also set to moderate in 2019: global earnings growth. In the U.S., the expected slowdown partly reflects a higher hurdle versus 2018 when corporate tax cuts provided a big boost to company earnings. U.S. earnings growth estimates look set to normalize from a heady 24% in 2018 to 9% in 2019, consensus estimates from Thomson Reuters data show. This is still above the global average. EMs are set to maintain double-digit earnings growth, led by China as its tech sector recovers and a pivot toward economic stimulus supports its economy. The U.S. and EMs remain our favored regions. Slowing growth and the impact of tariffs make for a more cautious corporate outlook. This could add to uncertainty in earnings estimates. The *Expectations meet reality* chart shows analysts' estimates have generally tracked lower from the start of the year, especially in Europe. The historical trend suggests earnings downgrades are largely priced into U.S. and EM stocks, whereas European estimates may be too optimistic given political and growth risks.

Corporate earnings growth is likely to slow in 2019, but we see U.S. and EM companies best positioned to deliver on expectations.

Slowing down

BlackRock Growth GPS for the U.S., eurozone and Japan, 2015-2018

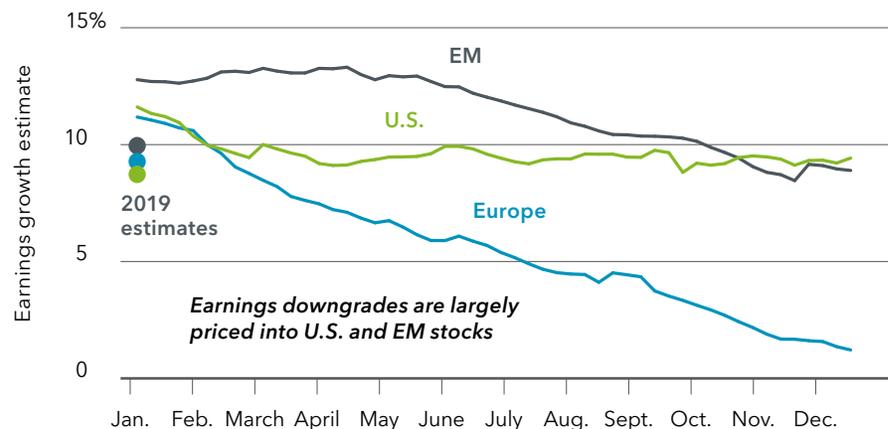


Sources: BlackRock Investment Institute, with data from Bloomberg, December 2018.

Notes: The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. Forward-looking estimates may not come to pass.

Expectations meet reality

Annual trend in analyst earnings estimates since 2008 vs. current 2019 forecasts



Source: BlackRock Investment Institute, with data from Thomson Reuters and IBES, December 2018. Note: The lines show the trend in average annual earnings growth estimates throughout a calendar year, from 2008 to 2018. The last four weeks of 2018 assume no change in analyst growth estimates. The 2019 estimates are as of December 2018. The respective MSCI indexes are used to represent the U.S., European and EM markets. It is not possible to invest directly in an index.

Theme 2: nearing neutral

U.S. financial conditions are still relatively loose, but they are tightening.

Why does this matter? Financial conditions are key to the near-term growth outlook. But financial conditions are tough to measure. Common gauges – which include interest rates, market volatility and asset valuations – can give misleading results. Example: Rising U.S. growth expectations can push up yields and the dollar, leading to the deceptive conclusion that financial conditions are tightening and growth is deteriorating.

Our new financial conditions indicator (FCI) seeks to avoid this problem by stripping out the impact of growth news on asset prices. It shows U.S. financial conditions are tightening. Moves in our FCI have historically led our growth GPS by around six months. All other things equal, this implies slowing, but above-trend growth in 2019, we believe. See the *Tightening time* chart.

Our gauge of financial conditions points to slowing growth in 2019 as the Fed tightens monetary policy further.

We see the process of tighter financial conditions pushing yields up (and valuations down) set to ease in 2019. Why? U.S. rates are en route to neutral – the level at which monetary policy neither stimulates nor restricts growth. Our analysis pegs the current U.S. neutral rate at around 3.5%, a little above its long-term trend. See the blue line in the *Getting to neutral* chart. Yet uncertainty abounds over where neutral lies in the long run (gray line): Our estimate sits in the middle of the 2.5% to 3.5% range identified by the Fed. We see a rate near the top of this range needed to stabilize the U.S. economy and debt levels. Yet we expect the Fed to become cautious as it nears neutral and pause its quarterly pace of hikes amid slowing growth and inflation in 2019. We see the pressure on asset valuations easing as a result. Europe and Japan will likely take only timid steps toward normalization. We don't expect the European Central Bank to raise rates before President Mario Draghi's term ends.

Nearing neutral could mean a relief from the tightening process that has weighed on asset valuations.

Tightening time

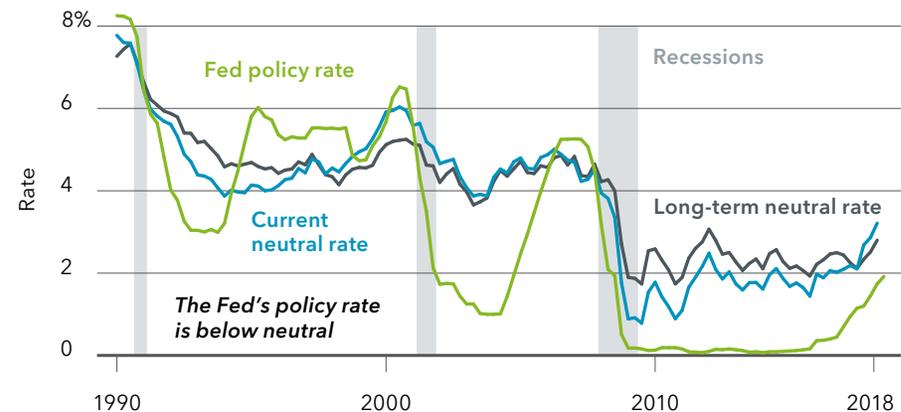
BlackRock U.S. Growth GPS vs. GDP growth implied by U.S. FCI, 2014–2019



Source: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, December 2018. Notes: The BlackRock U.S. Growth GPS (blue line) shows where the 12-month forward consensus GDP forecast may stand in three months' time. The green line shows the rate of GDP growth implied by our U.S. financial conditions indicator (FCI), based on its historical relationship with our Growth GPS. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. The U.S. FCI is moved forward six months, as it has historically led changes in the Growth GPS. Forward-looking estimates may not come to pass.

Getting to neutral

U.S. current and long-term neutral rates, and real policy rates, 1990–2018



Sources: BlackRock Investment Institute, Federal Reserve and National Bureau of Economic Research, with data from Thomson Reuters, November 2018. Notes: The chart shows U.S. policy rates with our estimate of current and long-term neutral rates. The neutral rates are estimated based on an econometric model from the July 2018 ECB working paper "The natural rate of interest and the financial cycle." This model takes into account financial cycle dynamics.

Theme 3: balancing risk and reward

Equities have taken a hit in 2018 despite solid earnings growth. Our analysis suggests increasing uncertainty (primarily around rising trade tensions) has been a major drag, offsetting robust fundamentals. Changes in growth expectations – also a key driver of real bond yields – have historically been a major driver of equity performance. The portion of equity returns *unexplained* by growth has grown in recent months. See the aqua shaded area in the *Uncertainty drag* chart. This increasing drag corresponds with a rise in market attention to the risk of Global trade tensions throughout 2018, as reflected in our *Geopolitical risk dashboard*. The risk is a further escalation that disrupts global supply chains, pressures corporate margins and hurts market confidence. [See page 8 for more.](#)

[Increasing uncertainty points to the need for quality assets in portfolios – but also potential for upside should market fears about trade ebb in 2019.](#)

Building resilient portfolios is about more than just dialing down risk.

Overly defensive positioning can undermine investors' long-term goals. We see rising uncertainty, along with tighter financial conditions, explaining the positive correlation between equity and bond returns in 2018. These risks look more priced into assets now and we expect growth to reassert itself as a driver of returns. This implies bonds should be more effective portfolio shock absorbers in 2019 – and calls for a barbelled approach, we believe: exposures to government debt as a portfolio buffer, twinned with high-conviction allocations to assets that offer attractive risk/return prospects.

Quality has historically outperformed other equity style factors in economic slowdowns, our analysis shows. See the *Style rotation* chart. We see EM equities as good candidates for the other end of the barbell. What to avoid? Assets with limited upside if things go right, but hefty downside if things go wrong. We see many credit and European assets falling into this category.

[We advocate allocations to quality bonds – twinned with targeted risk-taking in assets where the risk/reward looks most appealing.](#)

Uncertainty drag

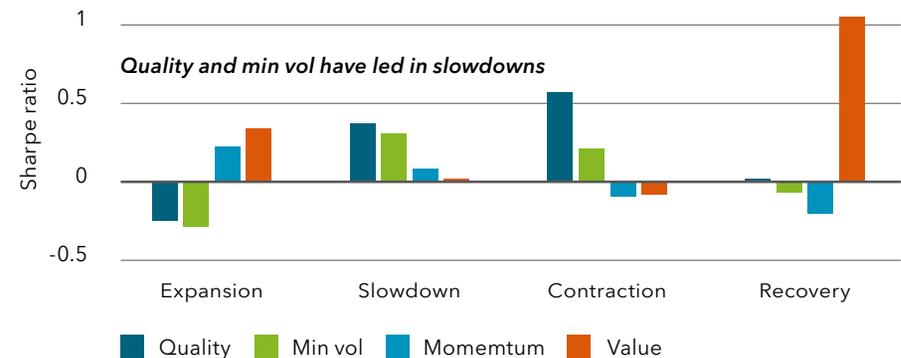
Estimated macro drivers of U.S. equity performance, 2016-2018



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, December 2018. Notes: S&P 500 Index returns are broken down into the "growth effect" and "uncertainty effect." We use co-movements in U.S. real yields and equities as a simple measure of the growth effect – markets pricing in changes in growth expectations – drawing on the methodology used in the 2014 IMF paper *News and Monetary Shocks at a High Frequency: A Simple Approach*. We label the portion of equity returns unexplained by growth as the uncertainty effect. In the inset chart, we plot the uncertainty effect against the BlackRock Geopolitical Risk Indicator (BGRI) for global trade tensions, as detailed on our [BlackRock geopolitical risk dashboard](#).

Style rotation

Equity style factor performance by economic phase, 2000-2018



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Bloomberg, November 2018. Notes: The bars show the Sharpe ratio of developed market equity style factors – broad, persistent drivers of equity market returns – over the four different stages of the economic cycle. We break down these stages of the cycle based on leading and coincident economic indicators. The Sharpe ratio is defined as the excess return (return versus the MSCI World Index) divided by the historical risk (standard deviation of excess returns) of the style factors over each cycle stage. Indexes used are MSCI World Value, MSCI World Momentum, MSCI World Quality and MSCI World Minimum Volatility.

Risks: rising recession fears

We see few signs of overheating in the U.S. economy today, and monetary policy is still easier than it was ahead of past recessions. This implies the current cycle still has room to run. But how far? Our analysis suggests the one-year forward probability of a U.S. recession is still relatively low, consistent with our base case for ongoing economic expansion in 2019. Yet the odds are set to rise steadily thereafter, with a cumulative probability of more than 50% that recession strikes by 2021. See the top right inset in the *Recession watch* chart.

Any rise in financial vulnerabilities such as excessive leverage could cut the cycle short. We see few warning signs so far. Asset valuations in public markets mostly look reasonable to us, household finances are in good shape, and corporate debt levels still appear manageable overall. One exception: We see rising vulnerabilities in the leveraged loan market.

We see this economic expansion grinding on through 2019, but the probability of recession rising beyond that as the cycle ages.

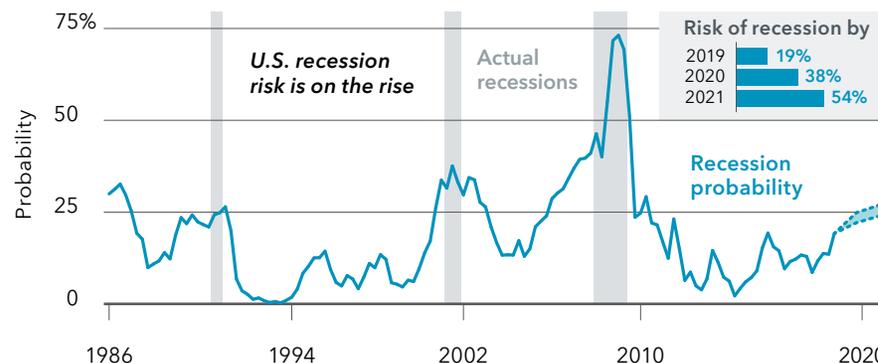
A rise in recession fears is a major risk for markets in 2019. What would such a sentiment shift mean for asset prices? We did a simple exercise looking back at the performance of different assets in periods preceding a U.S. recession in the past 40 years. What we found: Stocks can still do well late in the cycle. U.S. equities outperformed in the calendar year before a recession struck, as shown in the left-hand bars of the *Late-cycle investing* chart. But asset class fortunes started to shift as recessions drew nearer. U.S. Treasuries increasingly took the reins as investors sought cover (the right-hand bars).

We don't see recession on the immediate horizon, but with time comes increased risk, as detailed in the *Recession watch* chart. The key takeaway for investors: Stocks may still have some firepower in late cycle. We prefer equities with a quality bent, complemented with positions in core government debt as the cycle ages and growth scares creep in.

We see potential for late-cycle equity gains, but view portfolio shock absorbers such as U.S. Treasuries as key diversifiers as recession fears rise.

Recession watch

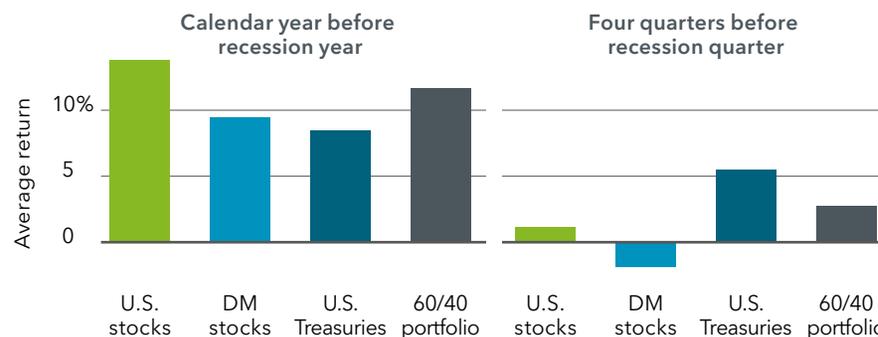
BlackRock estimate of forward-looking U.S. recession probability, 1986–2021



Sources: BlackRock Investment Institute, with data from Thomson Reuters, November 2018. Notes: The chart shows the estimated four-quarter-ahead probability of a U.S. recession. Actual U.S. recessions as defined by the U.S. National Bureau of Economic Research are denoted by the shaded areas. The estimation is done via a series of quantile regressions that estimate the probability that growth will be below a certain threshold. The 2019 and 2020 probabilities (shaded blue) are based on a range of likely outcomes of financial conditions, financial vulnerabilities and growth. The inset chart shows the cumulative probability of being in a recession by the end of each noted year. Forward-looking estimates may not come to pass.

Late-cycle investing

Average 12-month returns in periods preceding U.S. recessions, 1978–2018



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 Bloomberg and NBER, December 2018. Notes: The bars show average returns in selected assets in periods before U.S. recessions. The left-hand bars show the average returns in calendar years before the year in which a recession started. The right-hand bars show the average returns in the four quarters preceding the quarter in which a recession started. Recessions are as defined by NBER, with five recorded over the 40-year period. U.S. stocks are represented by the S&P 500 Index, DM stocks by the MSCI World Index, U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Total Return Index. 60/40 refers to a hypothetical portfolio of 60% S&P 500 and 40% Bloomberg Barclays U.S. Treasury Total Return Index, weighted monthly. Equities reflect price returns and bonds total returns, all in U.S. dollar terms.

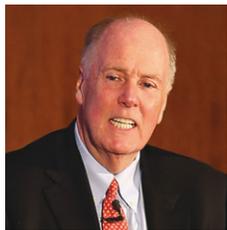
Risks: changing geopolitics

Europe has us worried. We expect no immediate flare-up in the region's political risk but believe investors are underappreciating medium-term threats to European unity. This, along with anemic growth and dependency on trade, has us underweight European risk assets. We see Italy's budget deficit stoking a protracted fight with Brussels, and could see further pressure on Italian bonds and other assets sensitive to European political risks against a backdrop of slowing growth across the eurozone. See the *Geopolitical sting* chart.

The end game is nigh for Brexit. We see odds of a no-deal exit in March as low, but expect a bumpy road ahead. A second referendum is not impossible. Another European question mark: Will the ECB raise rates? We think not. **See page 5.** Elsewhere, we believe country-specific risks may have peaked in much of the emerging world, but will be on election watch in Argentina, India, Indonesia and South Africa. See the *Save the dates* chart.

European political risks are front and center as EM-specific worries recede.

Trade frictions look more baked into asset prices than a year ago. Equity markets have cheapened, particularly segments sensitive to key risks such as U.S.-China tensions. See the *Geopolitical sting* chart. We could see the two rivals strike a modest deal that extends a fragile 90-day trade truce. But we expect frictions related to China's industrial policy and competition for global technology leadership to persist in the long run. There is bipartisan support in the U.S. for taking a tough line on China across the spectrum, from trade to militarization of the South China Sea. We could see trade tensions with the EU flare up, with the threat of U.S. auto tariffs looming.

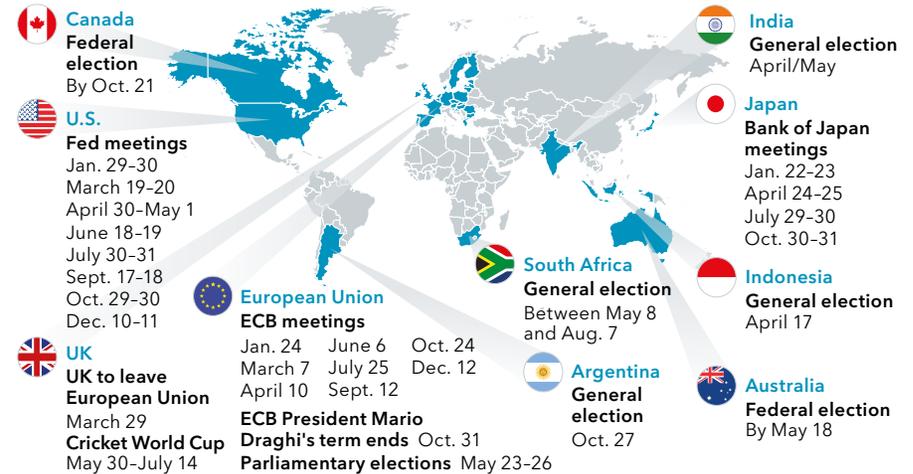


"The U.S. believed once China secured more wealth, it would embrace Western values. The Chinese thought Trump was a deal-maker and they could adjust at the margins. Both misread."

Tom Donilon – Chairman, BlackRock Investment Institute

Save the dates

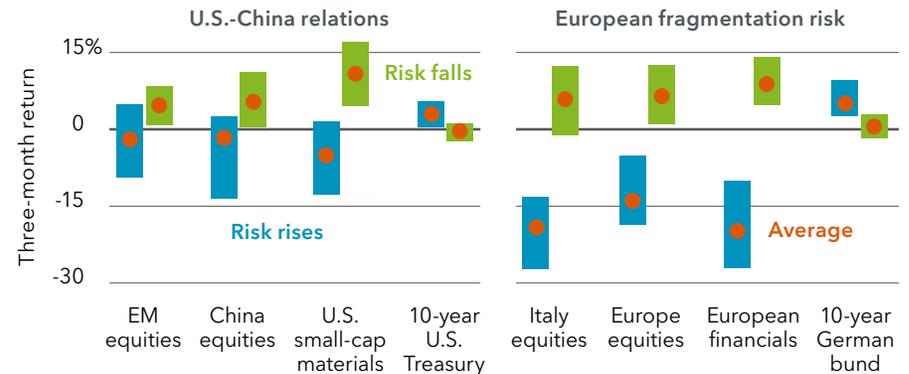
Events to watch in 2019



Source: BlackRock Investment Institute, November 2018. Notes: The ECB meetings are those accompanied by press conferences. The BoJ events shown are followed by the publication of the central bank's outlook report.

Geopolitical sting

Asset returns around sharp changes in geopolitical risks, 2005-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, November 2018. Notes: The chart shows the 25%-75% percentile range and average three-month returns for selected assets during rolling three-month periods when the BlackRock Geopolitical Risk Indicator (BGRI) rises (blue bars) or falls (green bars) by more than one standard deviation. MSCI USD Index price returns are used for equities, and Thomson Reuters benchmark index total returns are used for bonds. Visit <https://www.blackrockblog.com/blackrock-geopolitical-risk-dashboard> to see the full methodology. **This is not a recommendation to invest in any particular asset class or strategy, nor a promise or estimate of future performance.**

Outlook debate: emerging markets

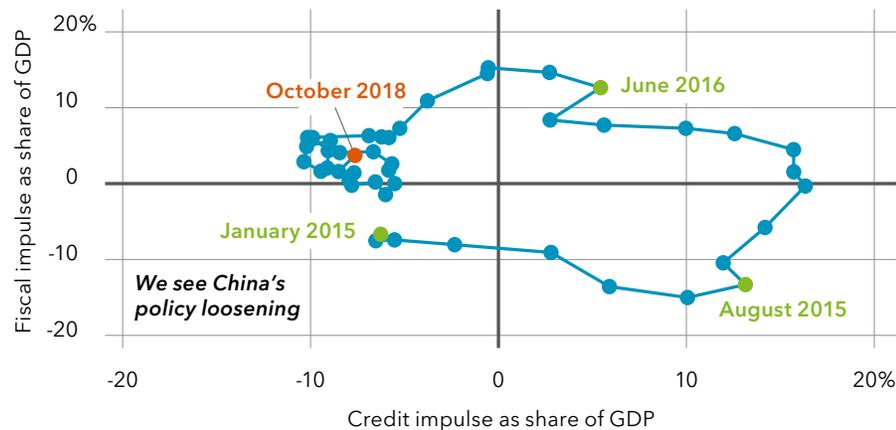
Emerging market assets have cheapened – offering better compensation for risk in 2019. Country-specific risks – such as a series of EM elections and currency crises in Turkey and Argentina – look to be mostly behind us. China is easing policy to stabilize its economy, marking a sea change from 2018’s clampdown on credit growth. We see the credit impulse turning positive in 2019 and fiscal policy becoming supportive. This would mark a return to the top-right quadrant of the *Stimulus swirlogram* chart.

Other positives for the asset class: The Fed is closer to the end of its tightening cycle and may pause rate hikes and/or balance sheet reduction in 2019. And economies are adjusting: Currency depreciations have led to improved current account balances in many EM economies. The key risk for EM assets: The Fed tightens faster than markets anticipate, renewing the dollar’s uptrend and tightening financial conditions for countries with external liabilities.

We are cautiously positive on EM assets for 2019.

Stimulus swirlogram

China’s fiscal and monetary stimulus, 2015–2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, November 2018. Notes: The fiscal impulse is defined as the 12-month change in the annual fiscal deficit as a percentage of GDP. The fiscal deficit includes spending from China’s general government fund. The credit impulse is defined as the 12-month change in the rate of broad credit growth as a share of GDP.

A surprisingly persistent downdraft in EM assets this year prompted reflections on lessons learned – and a spirited debate about the prospects for EM debt and equities in the year ahead. Some excerpts from the discussion:

“EM vulnerabilities and shocks have been moderate, and absorbers are in place – yet prices have dived. A pernicious explanation: Shallow domestic markets mean that small changes in the availability of external funding quickly propagate.”



Amer Bisat – Head of Sovereign and Emerging Markets Alpha, BlackRock Global Fixed Income



“When long-term correlations break, we need to pay attention. Examples are the jump in EM currency volatility and the unusual underperformance of EM high yield versus IG. We favor quality and a barbell approach in such an environment.”

Pablo Goldberg – Head of Research, BlackRock’s Emerging Market Debt team

“You have to really worry about EM politics and EM corporates when you have a long period of growth that gets into presidents’ and CEOs’ heads. As EM is fairly early in the cycle, we are less likely to see stupid behaviors.”



Sam Vecht – Head of Emerging Europe and Frontiers team, BlackRock Fundamental Active Equity



“There’s upside potential for Chinese equities if fiscal and monetary stimulus goes hand in hand with growth-boosting measures such as land reform. Other catalysts are abating trade tensions and a weaker U.S. dollar.”

Helen Zhu – Head of China Equities, BlackRock Fundamental Active Equity

Outlook debate: value investing

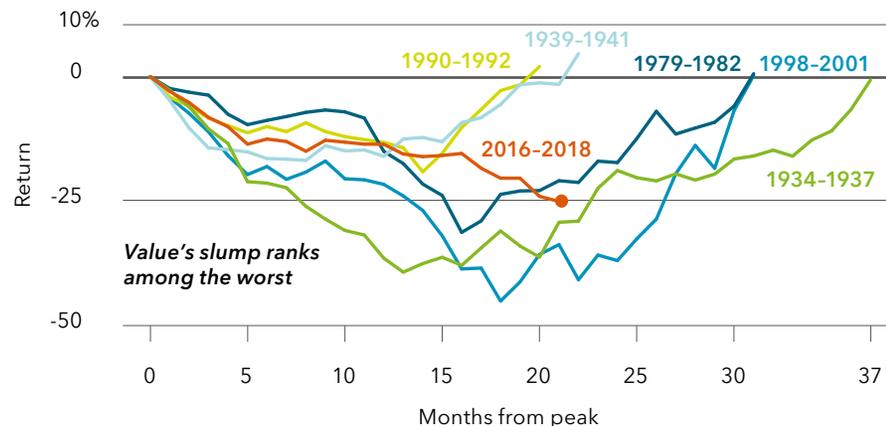
It's been a tough slog for value investing. Buying assets at a discount in an effort to reap rewards once the market catches on to their potential has not been in vogue (or at least not rewarded) for most of the past 10 years. The current drawdown is the fourth most severe in history, with value's fall from its most recent peak clocking at more than 20 months. See the *Seeking bottom* chart. Does this imply a buying opportunity, or is value irreparably broken?

Believers see a value comeback, arguing a stock's price cannot forever drift from its fundamentals. Value can offer balance, we believe, helping to offset declines in other styles and assets. Skeptics argue technological disruption has created more losers – cheap stocks that will stay cheap. Timing a recovery is difficult, but we still see value posting positive long-run returns. The 2018 drawdown was driven by developed markets; EMs held in. Value is being rewarded in countries with reform momentum, we find.

We see a place for the value style in a well-balanced portfolio.

Seeking bottom

Worst periods of U.S. value equity performance versus growth, 1934-2018



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Kenneth R. French data library at Dartmouth College, November 2018. Notes: The lines show the return of value during its worst-performing periods since 1934, starting from the month when performance peaked. The return is represented by HML (high minus low), or the average return on value equities minus that on growth equities, as defined by the Fama/French 5 Factors methodology.

Is value temporarily down or completely out? Some of us are optimistic that the style can turn the corner in 2019 and overtake growth; others less so. Here are selected excerpts from our discussion at the 2019 Outlook Forum:

“There are three ways in which the valuations of cheap stocks can ‘normalize:’ 1) prices recover, 2) earnings fall or 3) there’s a new (lower) normal. Determining what may propel value also requires thinking of what may *impede* growth.”

Katie Day – Head of Risk & Quantitative Analysis, BlackRock Fundamental Equities, Americas

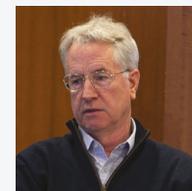


“Value has been a persistent driver of returns. That alone means it deserves a place in a balanced portfolio. Rather than asking why be in value, ask what it would mean for your portfolio when the trendy trade (momentum) reverses.”

Ked Hogan – Head of Investments, BlackRock Factor-Based Strategies

“We look for companies with durable growth and high free cash flow yields – those that can take market share and are beneficiaries of structural trends such as global payments.”

Lawrence Kemp – Head of BlackRock’s Fundamental Large Cap Growth Team



“Value has performed best when economic growth is accelerating. So the low-rate, meandering-growth environment of the past 10 years has not been kind. It may take a recession and growth resurgence for value to definitively reassert itself.”

Carrie King – Portfolio Manager, BlackRock Fundamental Active Equities

“The key question is: Are the underlying assets that are out of favor still economically sound? You need value with a pulse.”

Tom Parker – Chief Investment Officer of BlackRock Systematic Fixed Income



Outlook debate: contrarian thinking

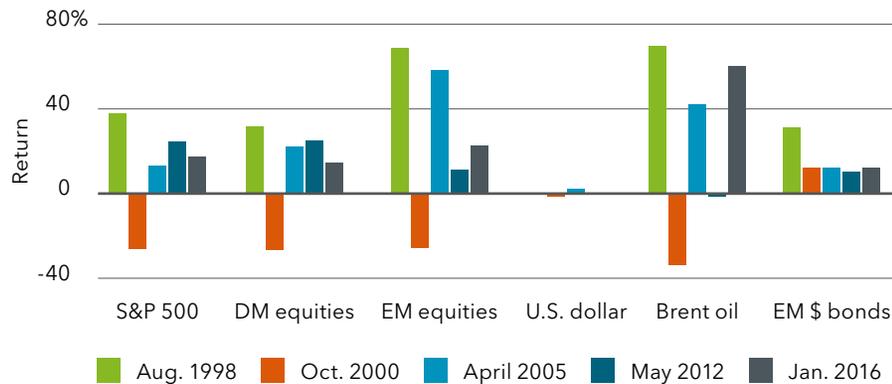
We find rising economic uncertainty, increasingly volatile markets and rapid technological disruption put a premium on adaptiveness and versatility.

The implication: Investors need to constantly question their investment theses, seek out fresh ideas and be ready to change course quickly. To encourage this, we run a contrarian session at our outlook forums where our portfolio managers challenge consensus views. See excerpts on the right.

Our Systematic Active Equities (SAE) team presented a quantitative analysis that went against the grain. It showed the five most similar historical periods based on the recent return pattern of asset prices. Most of them were followed by a rebound in risk assets. See the *Risk rebound?* chart. The early 2000s recession was the exception. SAE purely looks at market dynamics, as opposed to taking an economic cycle approach. The analysis goes against defensive strategies championed by those worried about late-cycle jitters. Food for thought.

Risk rebound?

12-month returns after historical periods most similar to the current environment



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 Bloomberg, November 2018. Notes: We look at a vector of returns across asset classes and use statistical techniques to determine how similar the past quarter's market dynamics are to other periods of time. We then rank the periods from most similar to least similar. The bars show the forward 12-month returns following the five most similar periods. MSCI indexes used for DM and EM equities. DXY index used for U.S. dollar. JP Morgan EMBI Global Index used for EM Hard Currency bonds. We use MSCI benchmark indexes for the global data.

We structure debates between our portfolio managers at our semi-annual outlook forum. Topics, speakers and formats change, but one perennial is a contrarian session where we challenge "group think." Highlights:

"You really have to squint to see something that gets you worried about inflation. But there is a disconnect between the qualitative view that populism is on the rise and the general lack of worry about inflation. If you look at history, populists kind of like inflation. If we are moving to an environment where supply chains get re-nationalized and populism becomes mainstream, don't we have more of a tail risk of inflation?"

Russ Koesterich – Portfolio Manager, BlackRock Global Allocation team

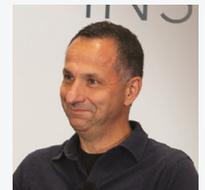


"Is there really a business cycle today? We have talked about the effects of technological disruption and the substitution of capex for R&D. The capex overbuild and inventory build-ups of the past had to be worked off for the cycle to end. Does that happen in a world of just-in-time inventories? I'm not sure this dynamic takes place going forward. Can we have a rolling economy that slows a bit, and the system recalibrates?"

Rick Rieder – Chief Investment Officer of BlackRock Global Fixed Income

"There are a few things we emotionally want to believe will revert to 'normal:' trade, some of the geopolitics or international alliances that affect the basic ways we go about our business. We want an environment we understand. But it's a wild world out there, and we need to evolve and change substantially. As an investor, you have to work extra hard to reinvent yourself constantly and change practices you've established over decades to succeed in a new world."

Raffaele Savi – Co-Chief Investment Officer of BlackRock Active Equity



Bonds

Rising rates have made shorter-term U.S. bonds an attractive source of income. Short-term Treasuries now offer almost as much yield as the 10-year Treasury, as shown in the *Short beats long* chart. That's with one-fifth the duration risk, we calculate. The picture is similar in credit. We are warming up to longer-term debt as a portfolio buffer against any late-cycle growth scares and a potential source of capital gains should the yield curve invert. It is a different story for non-U.S.-dollar investors facing lower short-term rates. Currency hedging costs have spiked for euro- and yen-based investors, wiping out the yield advantage of U.S. debt. We are neutral on Italian debt (attractive yields offset by political risks) and short UK duration, as we see the Bank of England resuming rate increases post-Brexit. We see Japan's yield curve steepening as its central bank loosens its grip on 10-year yields.

We see U.S. bonds as a key source of income and portfolio ballast.

There are signs of late cycle in credit. Financing costs are on the rise, input costs are up, and companies at the low end of the investment grade spectrum (BBB-rated) have been issuing more bonds to fund share buybacks and acquisitions. See the *Fallen angels in the making?* chart. Yet credit fundamentals generally look solid, with ample interest coverage. And companies have options for keeping their investment grade status, such as cutting dividends. We take an up-in-quality stance in credit, and overall see limited upside and asymmetric downside as the economy enters into a late-cycle phase. We prefer to take economic risk in equities, rather than in credit. And we see U.S. government bonds as a source of ballast in portfolios.



"There are times you can get away with things you don't love given a good market environment. But now you'd better like what you own. Security selection gets more important as the cycle ages."

Jeff Cucunato – Portfolio Manager, BlackRock's Global Credit group

Short beats long

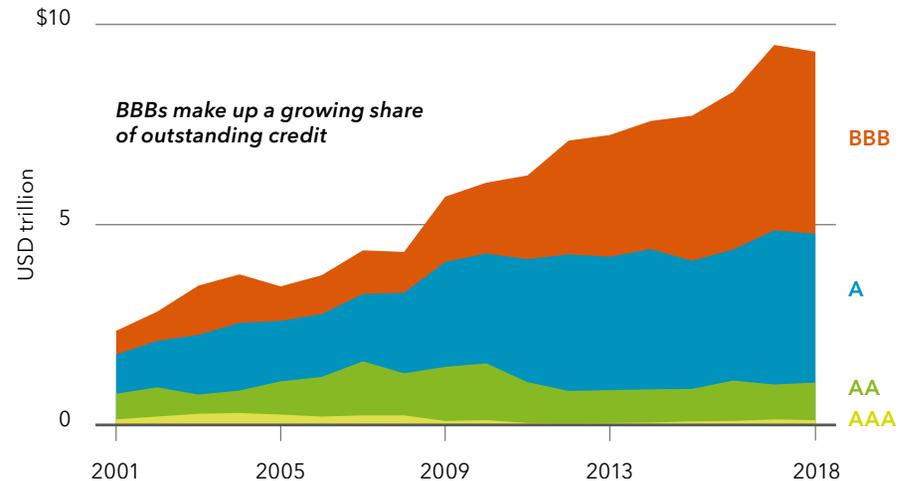
Ratio of short- to longer-term U.S. bond yields, 2010-2018



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, December 2018. Notes: The green line shows the yield of two-year U.S. government bonds as a percentage of the yield of 10-year U.S. government bonds based on Thomson Reuters benchmark indexes. The blue line shows the same metric for the Bloomberg Barclays 1-3 year U.S. investment grade credit index relative to the Bloomberg Barclays 10-year+ U.S. investment grade credit index.

Fallen angels in the making?

Global investment grade corporate bond issuance by rating bands, 2001-2018



Sources: BlackRock Investment Institute, with data from Bloomberg, November 2018. Notes: The chart shows a breakdown of the Bloomberg Barclays Global Corporate Index based on market value by rating bands. The 2018 numbers are as of Oct. 31.

Equities

Lofty 2018 earnings won't repeat, yet we are optimistic on equities. Solid earnings went largely unrewarded in 2018. Multiple contraction was among the top-10 worst in all regions since 1988, MSCI data show. The market paid a lot less for a given level of earnings. It was the third-worst year in the past 30 for the U.S. See the *Unrewarded* chart. Returns were more often positive the year after major multiple contractions, as the chart shows.

The U.S. remains a favored region. Valuations are high but we find prospects for earnings growth stronger than in other regions. Lowered EM valuations open an attractive entry point amid a solid earnings outlook and China's focus on economic stabilization. Europe is an underweight given political risks and a fragile economy vulnerable to the effects of any recession; financials would be most at risk. Europe's equity market is also heavy on lower-quality, cyclical companies that tend to lag in late cycle. We remain neutral on Japan.

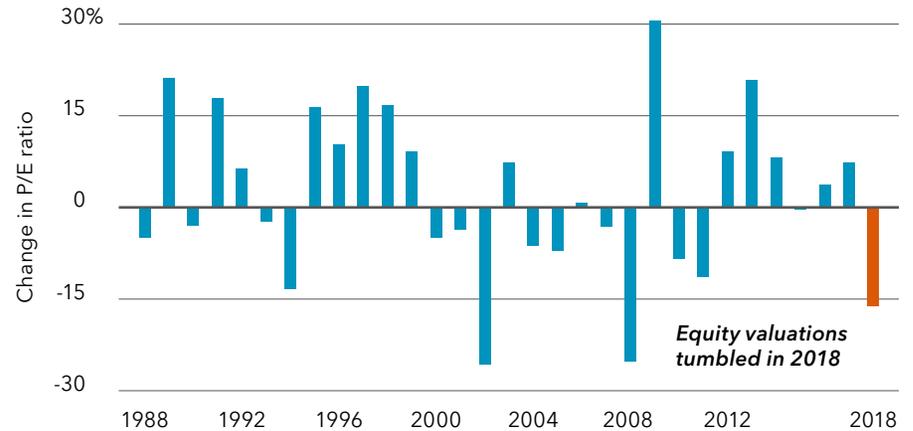
We favor U.S. and EM equities and maintain an underweight in Europe.

Quality is key as the cycle matures. We see quality, minimum volatility and large caps offering attractive risk-adjusted returns in 2019. Our markers for quality include strength in free cash flow, growth and balance sheets. One sector where this is prevalent: health care. The sector also shows low sensitivity to global growth, which historically has provided resilience in late cycle. See the *Seeking healthy fundamentals* chart. Our view is supported by positive demographic and innovation trends, and a strong earnings outlook among defensive sectors. We favor pharmaceuticals, managed care and medical technology. We're not ready to throw in the towel on the tech sector. We see much of the recent selling driven by one-off pressures on some of the mega-caps and wary investors trimming their overweights. The good news: The earnings and balance sheets for many tech companies still look healthy. This keeps them in our "quality" bucket. The caveat: Health care and tech valuations have risen versus the market average, and regulatory scrutiny of both sectors bears watching.

We like the health care sector for its appealing late-cycle potential.

Unrewarded

Annual change in forward U.S. price-to-earnings multiples, 1988-2018



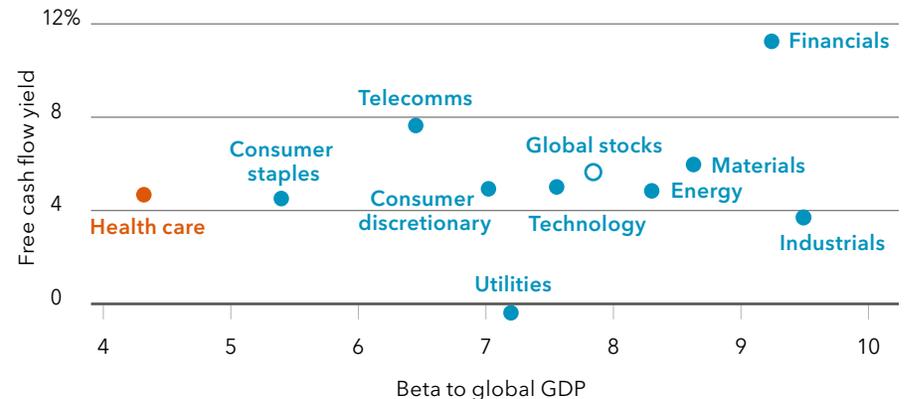
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute, with data from Thomson Reuters and IBES, November 2018.

Notes: The bars show the annual percent change in the ratio of price to 12-month forward earnings estimates from January to December of each year for the MSCI USA Index.

Seeking healthy fundamentals

Free cash flow yield and sensitivity to global growth by sector, 2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, Bloomberg and Oxford Economics, November 2018. Notes: The dots represent the trailing 12-month free cash flow yield versus the beta, or sensitivity, to global growth. Data are based on the MSCI ACWI index (the "global stocks" dot) and the noted sectors within it. Beta is calculated as the regression slope of a sector's quarterly price return versus the quarterly change in real GDP since 1995. Beta can be interpreted as the percent change in stock prices for each 1% change in global GDP.

Oil and currencies

We see prices stabilizing after an autumn slide sent oil into a bear market.

Oversupply was a key culprit in the downturn, but we believe the Organization of the Petroleum Exporting Countries (OPEC) and Russia can manage this by dialing back production. Output cuts have put a floor under prices in recent years. See the *Slippery slope* chart. Other potential catalysts for oil price stabilization: slower U.S. oil output growth in 2019 due to lower prices and rising demand amid still above-trend global growth.

Both energy-related equities and debt suffered to varying degrees along with crude. Yet we believe the price resets may open up attractive entry points for investors. We prefer equities focused on oil storage and transportation over exploration & production firms. We also see longer-term opportunities in oil field service companies, as U.S. shale is needed to help meet global demand in the 2020s.

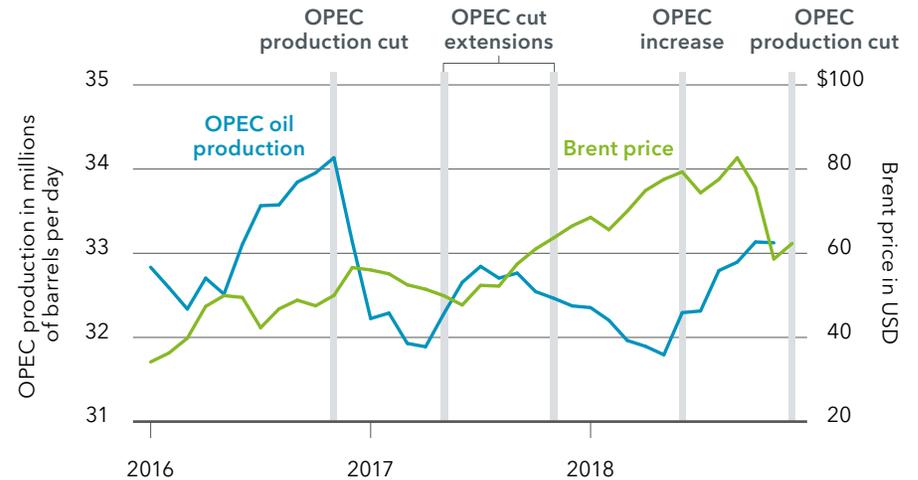
We see oil near bottom and believe selected energy equities look attractive.

Investor positioning in the U.S. dollar looks fairly neutral now. The *Longs and shorts of it* chart shows the once underowned dollar came a long way to re-earn investor attention in 2018. We see little impetus for further dollar strength given a relatively high valuation and few attributes that differentiate U.S. assets from the rest of the world. What could nudge the dollar higher? More Fed rate hikes than markets expect or any bursts of global risk aversion. EM currencies look more appealing after a sharp selloff this year, as many EM economies are in better shape to withstand shocks than during past crises. Investor sentiment has turned against EM currencies, as the chart's green line shows, setting them up for a reversal. The potential catalysts: a more dovish Fed or any easing of trade tensions. Rising EM currencies have historically gone hand in hand with rising EM asset prices. We see opportunities in EMs with reform and economic momentum, such as China, Indonesia and Brazil.

We believe the scope for further U.S. dollar gains is limited and see value in selected EM currencies after a sharp selloff.

Slippery slope

OPEC crude oil production and Brent crude price, 2016-2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters, December 2018. Notes: The blue line shows the level of OPEC crude oil production in million barrels per day. The green line shows the Brent crude oil price in U.S. dollars.

Longs and shorts of it

U.S. dollar and EM currency positioning, 2016-2018



Sources: BlackRock Investment Institute, with data from Bloomberg, CFTC, EPFR and State Street, November 2018. Notes: The data are based on BlackRock's analysis of portfolio flows, fund manager positions and price momentum. The EM currency analysis, however, excludes portfolio flows. A positive score means investors are overweight the asset class; a negative score indicates an underweight.

Assets in brief

Tactical views on selected assets, December 2018

▲ Overweight

— Neutral

▼ Underweight

Asset class	View	Comments
Equities	U.S.	▲ Solid corporate earnings and strong economic growth underpin our positive view. We have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our favoured 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	— We see a weaker yen, solid corporate fundamentals and cheap valuations as supportive, but await a clear catalyst to propel sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲ Attractive valuations and 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 much has been priced in. 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	— Higher yields and a flatter curve after a series of Fed rate increases make short- to medium-term bonds a more attractive source of income. Longer maturities are also gaining appeal as an offset to equity risk, particularly as the Fed gets closer to neutral and upward rate pressure is more limited. We see reasonable value in mortgages. Inflation-linked debt has cheapened, but we see no obvious catalyst for outperformance.
	U.S. municipal bonds	— Solid demand for munis as a tax shelter and expectations for muted issuance should support the asset class. We prefer a long duration stance, expressed via a barbell strategy focused on two- and 20-year maturities.
	U.S. credit	— Solid fundamentals support credit markets, but late-cycle economic concerns pose a risk to valuations. We favor an up-in-quality stance with a preference for investment grade credit. We hold a balanced view between high yield bonds and loans.
	European sovereigns	▼ Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials have made European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect quite a bit of risk.
	European credit	— Valuations are attractive, particularly on a hedged basis for U.S. dollar investors. We see opportunities in industrials but are cautious on other cyclical sectors. We favor senior financial debt that would stand to benefit from any new ECB support, over subordinated financials. We prefer European over UK credit on Brexit risks. Political uncertainty is a concern.
	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 reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

Note: Views are from a U.S. dollar perspective as of December 2018 and are subject to change at any time due to changes in market or economic conditions. *Given the breadth of this category, we do not offer a consolidated view.

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