BLACKROCK **INVESTMENT** INSTITUTE

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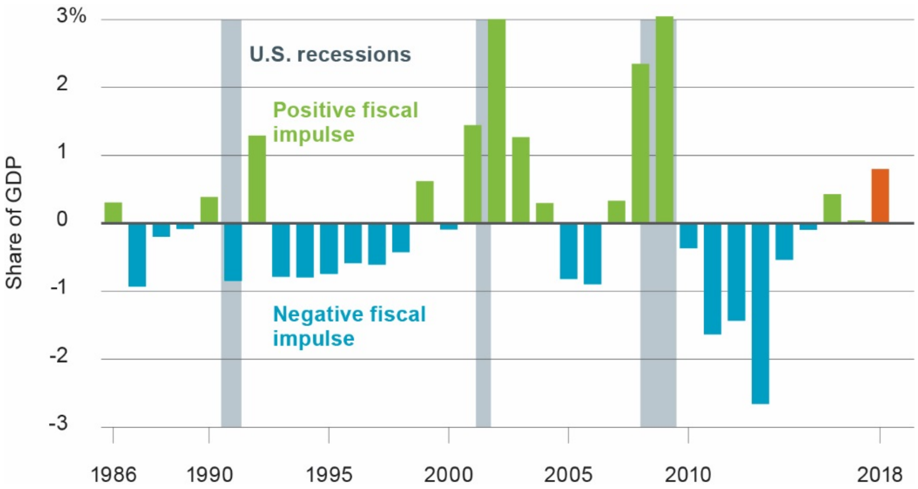
Key points

1. New fiscal stimulus should provide a boost to U.S. growth that bodes well for the global expansion and for investing in risk assets.
2. Global equity inflows broke records last week and U.S. stock indexes hit new highs. The U.S. dollar hit three-year lows versus the euro.
3. Changes to corporate guidance as a result of the U.S. tax overhaul will be in focus during the busiest week of fourth-quarter U.S. earnings season.

1 An upside U.S. growth surprise

The U.S. tax overhaul and higher expected federal spending point to faster growth just as the expansion enters its ninth year. This represents a sea change from U.S. fiscal policy's long drag on growth and bodes well for the synchronized, global expansion.

Chart of the week
U.S. fiscal impulse, 1986-2018



Sources: BlackRock Investment Institute, with data from the Organization for Economic Cooperation and Development (OECD), January 2018. Notes: The U.S. fiscal impulse is a measure of the contribution of fiscal policy to gross domestic product (GDP) growth. It is represented here as the change in the primary U.S. fiscal deficit (i.e., not counting net interest costs) as a percent of GDP. The deficit figures from the OECD are cyclically adjusted. The 2018 fiscal impulse bar is a BlackRock estimate incorporating the tax overhaul and likely spending increases

We expect the mix of corporate tax cuts, immediate capex expensing and higher federal spending to add 0.8 percentage point to 2018 U.S. real gross domestic product (GDP). This fiscal boost is the biggest in nearly a decade, as the chart shows, and should help cement the inflation comeback. We see scope for the Federal Reserve to lift rates four times this year rather than the three it has signaled – still a gradual pace. We estimate the U.S. cycle can power on for at least two to three more years. That brings the cycle's recessionary tipping point forward by about a year. If overheating pressures are contained, the expansion could press on for longer, in our view. More U.S. growth spilling abroad could underpin the global expansion, implying less domestic overheating.

It's a small world after all

Economies can run beyond potential for long stretches before peaking, especially when growth is just above trend, our research on economic cycles finds. Plus, some spare capacity persists globally, particularly in Europe. The global economy has never been so integrated at this point of an expansion, as we detail in *Heating up, slowly*, with world trade now making up about 50% of global GDP.

This lingering global slack should help moderate U.S. overheating and underpin the expansion, as U.S. stimulus spills abroad. The International Monetary Fund last week revised up its global growth forecast for 2018 in response to the U.S. tax overhaul. The plan features broad corporate tax cuts and allowances for companies to immediately expense capital spending. The incentive to raise capital spending could reinforce a business investment recovery that is underway. Stronger business investment should lift U.S. potential growth and lead to more U.S. imports. This is how the stimulus-growth boost could be shared beyond U.S. borders, and give the expansion more breadth and a longer lifespan. Deeply intertwined global trade and corporate supply chains mean demand is better redistributed around the world.

What are the risks? We particularly worry about U.S. trade actions – such as a U.S. trade war with China or a unilateral pull-out from the North American Free Trade Agreement - reversing decades of deeper global economic and financial integration. It is not our base case, but we recognize market sentiment can shift quickly and investors might fear that rising U.S. protectionism causes a downturn in global trade. We believe the global expansion can push on, assuming U.S. overheating pressures are contained with global help. This creates a solid foundation for investors to put money to work in risk assets, as we highlight in our *2018 Global Investment Outlook*.

2 Week in review

- Global equities saw record weekly inflows of more than $33 billion. U.S. stock indexes hit new highs and U.S. fourth-quarter earnings were solid. Mergers and acquisitions activity in the first three weeks of January surpassed $150 billion, the highest for that period since 2000.
- The U.S. dollar slid to a three-year low against the euro after comments from the U.S. Treasury secretary appeared to depart from longstanding U.S. currency policy. The U.S. imposed a 30% import tariff on washing machines and solar panels. The British pound hit post-Brexit-vote highs against the U.S. dollar. Gold rallied to a 17-month high.
- European Central Bank and Bank of Japan policy was unchanged, but currency moves suggested markets expected more dovish news. Eurozone economic data was strong, with the region's composite PMI at a nearly 12-year high.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.2%	7.5%	25.1%	1.8%
U.S. Small Caps	0.7%	4.8%	18.4%	1.1%
Non-U.S. World	1.9%	7.1%	30.8%	2.9%
Non-U.S. Developed	1.5%	6.5%	28.9%	3.1%
Japan	1.1%	7.7%	29.0%	1.9%
Emerging	3.3%	9.9%	41.9%	2.5%
Asia ex-Japan	2.7%	8.8%	44.5%	2.3%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.1%	-1.1%	1.2%	2.7%
U.S. TIPS	0.0%	-0.7%	1.8%	2.5%
U.S. Investment Grade	0.2%	-0.8%	5.5%	3.4%
U.S. High Yield	0.3%	0.9%	6.9%	5.6%
U.S. Municipals	-0.3%	-0.6%	4.4%	2.5%
Non-U.S. Developed	1.6%	3.2%	13.6%	0.9%
EM $ Bonds	0.3%	0.2%	9.2%	5.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	2.8%	5.5%	25.4%	$70.52
Gold	1.3%	3.6%	13.5%	$1,349
Copper	0.6%	-2.2%	21.0%	$7,085

Currencies	Week	YTD	12 Months	Level
Euro/USD	1.7%	3.5%	16.3%	1.24
USD/Yen	-2.0%	-3.6%	-5.2%	108.58
Pound/USD	2.2%	4.8%	12.4%	1.42

Source: Bloomberg. As of Jan. 26, 2018. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI indexes; U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg Barclays Global Aggregate ex USD; and emerging market $ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

Jan. 30 U.S. State of the Union address

Jan. 31 U.S. FOMC meeting and U.S. Treasury refunding announcements; eurozone inflation

Jan. 31-Feb 1 U.S. & China manufacturing PMIs

Feb. 2 U.S. employment report

This week is the busiest of fourth-quarter corporate earnings season in the U.S., with companies representing 40% of the S&P 500 reporting results. Changes to corporate guidance as a result of the U.S. tax overhaul will be in focus. So far, more than three-quarters of companies have beaten either earnings or revenue expectations. Key to watch is whether stocks of companies with both revenue and earnings misses will be disproportionally penalized, as they were in previous quarters. Elsewhere, it will be a major week for Japanese earnings and more reports will roll in out of Europe, where a strong euro could keep weighing on results.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	—	Earnings momentum is strong heading into 2018. U.S. corporate tax cuts should boost earnings. We like the momentum and value style factors, financials, technology and dividend growers.
	Europe	▲	We see sustained above-trend economic expansion and a steady earnings outlook supporting cyclicals. Euro strength is still playing out in company results and could cause more pain.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings amid a stable yen outlook. We see BoJ policy and domestic investor buying as supportive. Yen strengthening would be a risk.
	EM	▲	Economic reforms, improving corporate fundamentals and reasonable valuations support EM stocks. Above-trend expansion in the developed world is another positive. Risks include a sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia, and like Brazil and India. We are cautious on Mexico.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings appear solid in the near term. We like selected Southeast Asian markets but recognize a faster-than-expected Chinese slowdown would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We expect rates to move moderately higher amid a sustained economic expansion and a tightening Fed. Rising inflation and lower valuations give TIPS an edge over nominal Treasuries. We are neutral on agency mortgages, given full valuations and the uncertain effect of the Fed's unwinding its balance sheet.
	U.S. municipals	—	Increased issuance driven by tax reform expectations should reverse in 2018, creating a more supportive supply/demand balance. This, plus solid appetite for tax-exempt income, underpins the asset class. We favor maturities of 0-2 and 20+ years.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We prefer up-in-quality exposures as ballast to equity risk. Higher-quality floating rate instruments and shorter maturities appear increasingly well positioned for rising rates.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise, and spreads of semi-core and selected peripheral government bonds to narrow.
	European credit	▼	Ongoing ECB purchases have compressed spreads across sectors and credit-quality buckets. Negative rates have crimped absolute yields – and rising rate differentials make currency hedged positions increasingly attractive for U.S. dollar investors. Subordinated financial debt is less alluring versus equities after a strong 2017.
	EM debt	—	Gradual Fed rate increases favor local-currency exposures – especially their higher yields relative to major bond markets. A shift by EM central banks towards tighter policy reduces our return expectations. Solid fundamentals and inflows should limit EM currency volatility.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond landscape reflects its growing credit market. Higher quality growth and a focus on financial sector reform are long-term positives, but any China growth slowdown would be a near-term challenge.
Other	Commodities and currencies	*	Oil prices are underpinned by supply-and-demand rebalancing. The U.S. dollar has scope to strengthen against the euro and the yen in coming months, as the Fed's normalizing ahead of its peers looks to be underpriced for now.

▲ Overweight — Neutral ▼ Underweight

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

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