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BLACKROCK INVESTMENT INSTITUTE

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WEEKLY COMMENTARY • JUNE 25, 2018

Key points

1. We see solid fundamentals underpinning economic growth, but rising trade tensions increase uncertainty and may dent business confidence.
2. Emerging markets led stocks down. The U.S. dollar firmed. Equity and bond funds saw the biggest weekly outflows in over three years.
3. Populist candidate Andrés Manuel López Obrador is expected to win the Mexican election, raising questions on Mexico's future economic policy.

1 Trade wars: Don't panic, prepare

Trade tensions are here to stay. Even without a full-blown trade war, escalating frictions could weigh on business confidence – and growth. Economic fundamentals are still running strong and underpinning our risk-on view in the short term, but we advocate building increased resilience into portfolios as macro uncertainty rises.

Chart of the week

U.S.-China economic tensions and quality stocks' relative performance, 2016-2018

Past performance is not a reliable indicator of future results. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, with data from Thomson Reuters, June 2018. Notes: The blue line represents the score for the U.S.-China economic tensions risk within the global BlackRock Geopolitical Risk Indicator (BGRI). We identify specific words related to rising tensions in U.S.-China economic relations and use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving. The relative performance of quality stocks is the total return of the MSCI World Quality Total Return Index divided by that of the MSCI World Total Return Index, rebased to 100 at 2016.

Economic tensions between China and the U.S. have shot up, confirmed by our BlackRock Geopolitical Risk Indicator. This has coincided with an outperformance of quality stocks, as the chart shows. Investors appear to be heeding risks, trade included. Trade risks are not limited to China. The prospects of a North American Free Trade Agreement (NAFTA) deal have deteriorated. The European Union (EU) and others have retaliated against U.S. steel and aluminum tariffs, while the U.S. has threatened to impose tariffs on cars imported from the EU.

Tech rivalry is key

Prolonged tit-for-tat actions could affect the economy through two channels: First is the impact on confidence, which could lead companies to delay investment and spending. Second is the direct impact of tariffs as they push up costs and depress demand. The breadth and depth of global supply chains will amplify this impact. China-U.S. tensions run deep, with the U.S. trade deficit as the headline issue. Ultimately, a full-blown trade war is in neither party's interest. A limited agreement to reduce the U.S. trade deficit with China looks feasible. Yet we see rivalry in the technology sector as a more fundamental issue that could lead to enduring tensions.

China is unlikely to compromise on its key strategic goals in developing its high-tech manufacturing sector. A key event to watch: The U.S. government is expected to announce restrictions on inbound investments from China on June 30. These restrictions could affect the Chinese supply chain and harm the ability of its "national champion" companies to import critical technology – mostly from the U.S. What may lie ahead? We highlight three key signposts: Will there be deal discussions between senior officials of the two countries? How much pressure to retreat will the White House get from Republican legislators and U.S. firms? To what extent will U.S. companies in China be pressured by local authorities? The answers to these questions may provide some guidance as to whether the next move is toward a deal or more bouts of tit-for-tat. Yet some form of investment restriction is likely to come first.

We see solid fundamentals still underpinning global growth in the short term, but acknowledge that geopolitical risks such as trade tensions are amplifying macro uncertainty. Portfolio resilience is crucial now. We prefer up-in-quality exposures in fixed income, favoring investment grade debt. We also like hard-currency emerging market debt while avoiding highly leveraged assets. We like companies with strong balance sheets and earnings growth in equities, mostly in the U.S. Diversification and broad style factor exposures can also help buffer portfolios against potential market regime changes.

2 Week in review

- Global stocks fell on trade worries, led by industrials, materials and emerging markets (EM). Equity and bond funds globally posted their largest one-week outflow since late 2014. The dollar hit an 11-month peak.
- U.S. high yield debt extended its outperformance versus its investment grade (IG) peers. An IG supply glut from the recent takeover frenzy has weighed on the sector. Trade frictions have also hurt sentiment, as IG issuers tend to be globally oriented. This has improved IG's risk-reward balance versus high yield, supporting our up-in-quality stance.
- The Organization of the Petroleum Exporting Countries (OPEC) agreed to ease the oil output restriction. Oil prices rallied as the added production is expected to fall short of demand growth, particularly in the third quarter.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.9%	3.0%	13.2%	2.0%
U.S. Small Caps	0.1%	10.4%	21.5%	1.1%
Non-U.S. World	-1.2%	-2.8%	8.6%	3.2%
Non-U.S. Developed	-1.0%	-1.7%	7.9%	3.4%
Japan	-1.9%	-0.6%	11.4%	2.3%
Emerging	-2.3%	-5.3%	10.2%	2.9%
Asia ex-Japan	-2.9%	-2.6%	12.3%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.1%	-1.4%	-1.6%	2.9%
U.S. TIPS	0.3%	-0.4%	1.1%	3.0%
U.S. Investment Grade	-0.4%	-3.6%	-1.7%	4.1%
U.S. High Yield	0.0%	0.7%	3.5%	6.3%
U.S. Municipals	0.1%	-0.4%	0.9%	2.7%
Non-U.S. Developed	0.2%	-1.3%	2.9%	0.9%
EM $ Bonds	0.3%	-4.9%	-1.4%	6.4%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	2.9%	13.0%	67.1%	$75.55
Gold	-0.7%	-2.5%	1.6%	$1,271
Copper	-3.3%	-6.3%	18.2%	$6,789

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.4%	-2.9%	4.5%	1.17
USD/Yen	-0.6%	-2.4%	-1.2%	109.97
Pound/USD	-0.1%	-1.9%	4.6%	1.33

Source: Bloomberg. As of June 22, 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.

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3 Week ahead

June 28 Federal Reserve releases results of the Comprehensive Capital Analysis and Review (CCAR)

June 28-29 European Council meeting (with immigration policy set to be a big focus)

June 29 Flash eurozone inflation; U.S. personal consumption expenditures (PCE); China official Purchasing Managers' Index (PMI)

July 1 Mexican elections

Populist candidate Andrés Manuel López Obrador (AMLO) is widely expected to win the Mexican presidential election. He also appears likely to be able to engineer a majority in Congress. The big question for markets is what kind of president could he be. AMLO has recently toned down earlier rhetoric about rolling back structural reforms and has vowed to be fiscally responsible. We could see Mexican assets rebounding in the short run. The European Council meeting will be an important indicator of Europe's ability to overcome acute tensions such as the handling of migrants — and to press ahead with reforms to strengthen the EU's resilience to economic shocks.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Extraordinarily strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum and value style factors, as well as financials and technology.
	Europe	—	We see a sustained global expansion supporting cyclical sectors. The moderation in domestic growth and rise in political risks pose headwinds for earnings, especially for banks.
	Japan	▲	Positives are improving global growth, more shareholder-friendly corporate behavior and solid earnings. We see Bank of Japan policy buying as supportive. Any yen appreciation 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 further sharp rise in the U.S. dollar, trade tensions and elections. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging. China's growth and corporate earnings are solid. We like selected Southeast Asian markets but recognize a faster-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Shorter maturities offer a more compelling risk/reward tradeoff. They and inflation-linked securities can be buffers against rising rates and inflation. We like 15-year mortgages relative to their 30-year counterparts and to short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive of munis, but rising rates weigh on absolute performance. A more defensive stance is warranted near term, we believe, though any material weakness due to supply may represent a buying opportunity. We favor a barbell approach focused on two- and 20-year maturities.
	U.S. credit	—	Sustained growth supports credit, but high valuations limit upside. We prefer up-in-quality exposures as ballast to equity risk. Higher-quality floating rate instruments and shorter maturities are well positioned for rising rates, in our view.
	European sovereigns	▼	The ECB's negative interest rate policy has made yields unattractive and vulnerable to the improving growth outlook. We expect core eurozone yields to rise. We are cautious on peripherals given tight valuations, political risks in Italy and the prospect of the ECB reducing its asset purchases.
	European credit	▼	Recent spread widening driven by increased issuance has created some value, while ongoing ECB purchases should support the asset class. Negative rates have crimped absolute yields — but rising rate differentials make currency-hedged positions increasingly attractive for U.S.-dollar investors. Subordinated financial debt looks less compelling versus equities after a strong 2017.
	EM debt	—	Recent price moves have improved the valuations of hard-currency debt, increasing the relative attractiveness both to local-currency bonds and to developed market corporates. Further support for valuations comes from slowing supply and strong EM fundamentals. Trade fears or geopolitical risks prompting a rapid tightening of global financial conditions represent downside risks.
	Asia fixed income	—	Regional growth and inflation dynamics are supportive of credit. China's rising representation in the region's bond universe 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	*	Declining global crude inventories underpin oil prices, with geopolitical tensions providing further support. We are neutral on the U.S. dollar. Factors driving its recent strengthening are likely temporary, but higher global uncertainty and a widening U.S. yield differential with other economies may provide support.

▲ Overweight — Neutral ▼ Underweight

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

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