BlackRock

Global Investment Outlook

BlackRock Investment Institute

Midyear 2019

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Philipp Hildebrand
Vice Chairman
BlackRock

Jean Boivin
Head
BlackRock Investment Institute

The key change in our outlook is that we now see trade and geopolitical frictions as the principal driver of the global economy and markets. This leads us to downgrade our growth outlook further and take a modestly more defensive investing stance.

We expect a significant shift by central banks toward monetary easing to cushion the slowdown. This policy pivot should extend the long expansion, we believe, and has already triggered easier financial conditions. We remain positive on U.S. equities against a backdrop of reasonable valuations. Coupon income is key in a low-yield world, and we upgrade emerging market (EM) debt as a result. We believe markets are overly optimistic about China's efforts to boost growth, however, leading us to downgrade China-linked EM and Japanese equities.

The European Central Bank (ECB) has put stimulus tools back on the table, while the Federal Reserve is poised to cut interest rates as insurance against a downturn. We expect the ECB to deliver on stimulus expectations. We close our underweight in European equities and upgrade the region's bonds as a result. By contrast, we view the degree of Fed easing that markets are pricing in as excessive, given that we see limited near-term risks of recession. The possibility of a snapback in yields leads us to downgrade our tactical view on U.S. Treasuries.

The U.S. and China have entered into a strategic competition that we see as structural and persistent. The fallout is a potential rollback of decades-long globalization trends that gradually lowered inflation and expanded corporate profit margins. Could this eventually result in a supply shock that pushes down trend growth and ends disinflation? This is a scenario that markets are not prepared for — and could lead to negative returns in both equities and bonds. We prefer to dial down overall risk by raising some cash but still see an important role for long-term government bonds as portfolio stabilizers, especially on a medium-term horizon.

Elga Bartsch
Head of Macro Research
BlackRock Investment Institute

Mike Pyle
Global Chief Investment Strategist
BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist
BlackRock Investment Institute

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Buying time amid rising protectionism

Our June 12-13 Outlook Forum in London brought together roughly 100 BlackRock investment professionals to debate the prospects of the global economy, policy and markets. We give a flavor of the Forum's discussions , and refresh our themes and asset views in this publication.

We update our three 2019 investment themes in light of our view that trade disputes and geopolitical tensions are now the key drivers for the global economy and markets. A U.S.-led protectionist push has increased downside risks to the global economy — and widened the range of potential outcomes ahead. We highlight how a significant dovish shift by central banks could nevertheless buy investors time, stretching this economic cycle and supporting risk assets. We explain how the uncertain global backdrop argues for a more overall defensive approach in portfolios. See the boxes on the right — and the following three pages for a deep dive on each theme.

Structural U.S.-China competition is at the center of geopolitical uncertainty. The tensions go beyond trade, extending to strategic concerns over domination of next-generation technologies and their implications for national security. See page 7. We explain the pivotal role of China's economy and why we believe markets may be overestimating the country's efforts to boost growth (page 8). We then examine how investors can deal with low for longer bond yields (page 9).

Our Outlook Forum featured two key debates. We discussed whether deglobalization could gradually reverse a long trend of subdued inflation, steady productivity growth and soaring corporate profit margins (page 10). And we debated how central banks can respond to the low-growth, low-inflation environment (page 11). Lastly, we detail our asset views for the next six to 12 months (pages 12-15).

Protectionist push

We are downgrading our global growth outlook as trade disputes and broader geopolitical tensions stoke greater macro uncertainty. The range of potential economic and market outcomes further ahead has widened. We see a lull in China's growth due to the fallout of U.S. tariffs.

Implication: We favor reducing risk amid rising protectionism, including raising some cash.

Stretching the cycle

The decisively dovish shift by central banks has depressed long-term yields and should help extend the long expansion. This makes for a benign near-term environment for risk assets, in our view, although uncertainty around the outlook has risen.

Implication: We stay positive on U.S. equities and like EM debt's income potential in a low-yield world.

Raising resilience

We believe portfolio resilience is crucial at a time of elevated macro uncertainty. We define resilience as the ability of a portfolio to withstand a variety of adverse conditions — both on a tactically defensive basis and strategically across cycles.

Implication: Government bonds play an important role in building portfolio resilience — even at low yield levels.

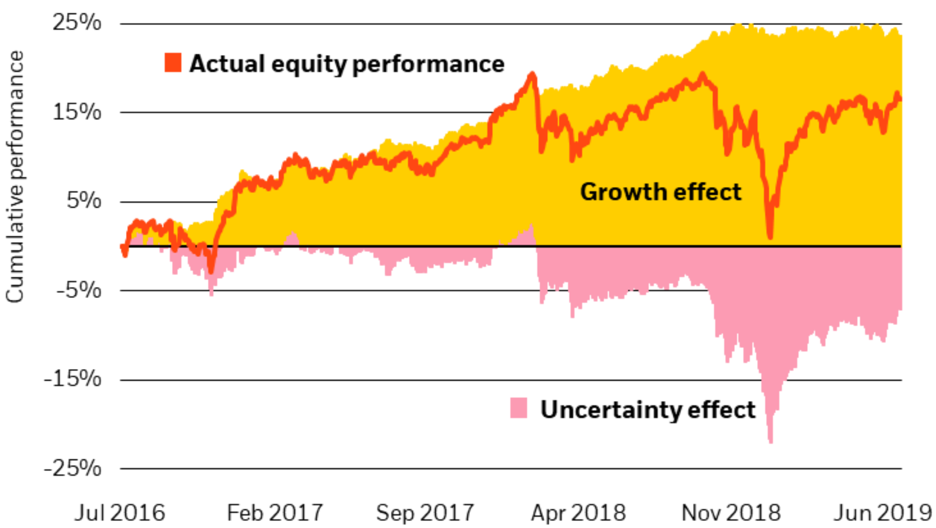
Themes

Protectionist push

Geopolitical tensions have heightened macro uncertainty, leading to a wider range of potential economic and market outcomes ahead. The escalation in trade conflicts between the U.S. and its major trading partners has become the primary risk to the long global expansion, in our view, rather than traditional late-cycle concerns relating to overheating or recession. In the near term, tariffs and the uncertainty around trade policy could deliver a one-off boost to prices, damage business confidence, and discourage capital spending. This comes at a time when our Inflation GPS already points to upside risk in U.S. inflation in coming months.

Nagging uncertainty

Estimated drivers of developed market equity performance, 2016-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2019.
Past performance is not a reliable indicator of current or future results. Notes: The chart shows the cumulative performance of the MSCI World Index rebased to 0 on July 1, 2016. The performance is broken down into the "growth effect" and "uncertainty effect". We estimate the degree to which developed market real yields and equities move together 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. It is not possible to invest directly in an index. Indexes are unmanaged and not subject to fees.

The longer-term risk: The unraveling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation. We find that the uncertainty stemming from the trade threats and tit-for-tat responses have already taken a toll on developed market equities. See the *Nagging uncertainty* chart. We break down the cumulative performance of DM equities by determining whether the joint moves in equities and government bond yields are driven by changes in growth expectations or factors unrelated to growth – which we attribute to uncertainty.

The uncertainty effect has hovered sideways since the start of the year and, therefore, may not have taken on board the escalation in trade tensions. This poses risks to equity markets as we expect the strategic tensions between the U.S. and China to persist, even if markets cheer a temporary truce on trade. See page 7. As a result, we favor moderately reducing portfolio risk overall. For U.S. dollar investors this may include an allocation to cash-like instruments.

Trade tensions have already caused global growth to slow and we expect further fallout that may weaken domestic spending. Yet central banks have been quick to pivot to more dovish policy stances. This indicates they are ready to provide more stimulus to reduce downside risks, even though it is not clear that monetary policy stimulus can effectively offset the protectionist push. We expect U.S. growth to cool to around trend-like levels just below a 2% annual rate. The eurozone is steadying after last year's abrupt slowdown, in part caused by China.

China's growth is finding its footing but looks to be at risk of staying sluggish due to the tariff fallout. We expect Beijing to be quick to roll out fiscal stimulus to help underpin growth if the economy wobbles but believe markets are overly optimistic about the effect. We expect any stimulus to stabilize growth, but not to accelerate it. See page 8. Overall, we see weaker growth in China and its fallout on the eurozone limiting any upside to global growth.

Our bottom line: We are downgrading our global growth outlook as trade disputes stoke greater macro uncertainty.

We favor reducing risk amid rising protectionism, including raising some cash for U.S.-dollar investors.

Themes

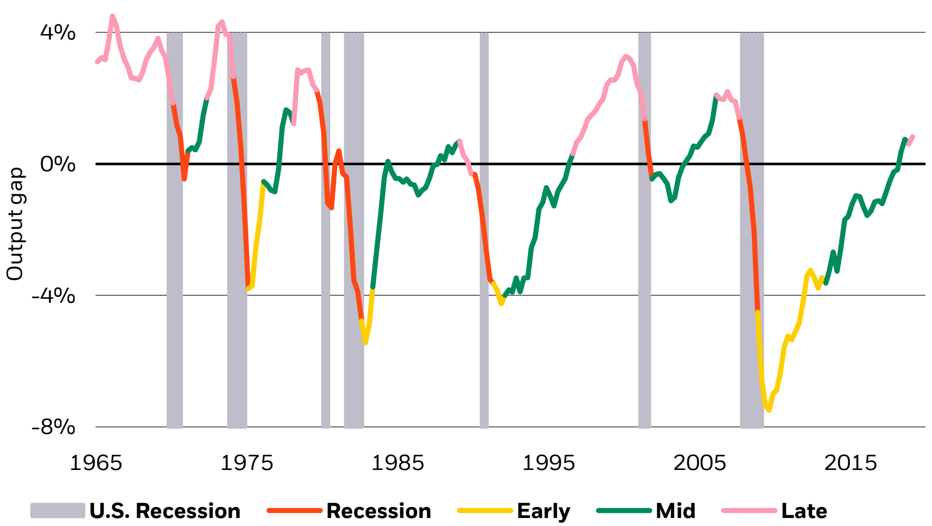
Stretching the cycle

The record-long U.S. economic expansion looks unlikely to run out of steam any time soon. We see a limited near-term risk of the traditional catalysts that bring expansions to an end — financial vulnerabilities leading to dislocations or deleveraging, or economic overheating that prompts central banks to overtighten policy. The U.S. economy has only recently hit full capacity, entering the "late" stage of the cycle that can often run for an extended period. See the *Stretching the cycle* chart and our Putting economic cycles in context interactive graphic.

Our BlackRock macro dashboard indicates global growth should decelerate further but sees the global expansion running on for longer, with central banks helping support looser financial conditions.

Stretching the cycle

Output gap and stages of the U.S. business cycle, 1965-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, as of July 2019.
Notes: This chart shows an estimate of the U.S. output gap (that is, GDP as a percentage of potential GDP). We have classified different time periods as belonging to certain stages of the business cycle. The classification of the stage is done via a 'cluster analysis' that groups together time periods where economic series have behaved in similar ways.

The Fed appears ready to counter the downside risks to growth brought about by escalating trade conflicts. Other central banks, including the ECB, have joined the Fed in its commitment to cushion the economy against a slowdown. The Fed is poised to deliver insurance rate cuts as short-term U.S. interest rates still are in accommodative territory below our estimates of neutral rates — those that neither foster nor restrict economic growth.

We see the ECB providing additional stimulus — in the form of a shift in forward guidance, lower rates or a restarting of quantitative easing (QE) — ahead of the end of President Mario Draghi's term in October. Elsewhere, the Bank of Japan is mulling more stimulus measures as inflation shows no sign of reaching target and the yen has remained strong. Yet it has limited policy room with already sizable asset purchases and a negative policy rate.

The decisively dovish turn in global monetary policy since the start of the year and resulting plunge in bond yields bode well for risk assets, in our view, barring any major escalation in geopolitical tensions. We see asset valuations as reasonable in both equity and credit markets, particularly in a world of structurally lower interest rates over the long run. This argues for maintaining sizable equity exposure, especially to U.S. stocks, and favors high-yielding EM debt because we see income as crucial in a low-yield world. See pages 13-14.

What are the key risks? Global trade and strategic tensions between the U.S. and China could escalate or broaden to the Americas, Europe or other Asian economies. This could hit market sentiment, lead to an extended lull in major economies and weigh on global growth. Even if monetary and fiscal policy support helps extend the life of this cycle, we could still face the prospect of slower growth and higher inflation. Heightened macro uncertainty could also herald a shift to a new regime of more frequent risk asset selloffs and higher financial market volatility. It is why we believe that building portfolio resilience is critical as this cycle continues to age.

Our bottom line: The extended expansion buys investors time to build more resilience into their portfolios.

We remain positive on U.S. equities and see credit as an attractive source of income in a low-yield world.

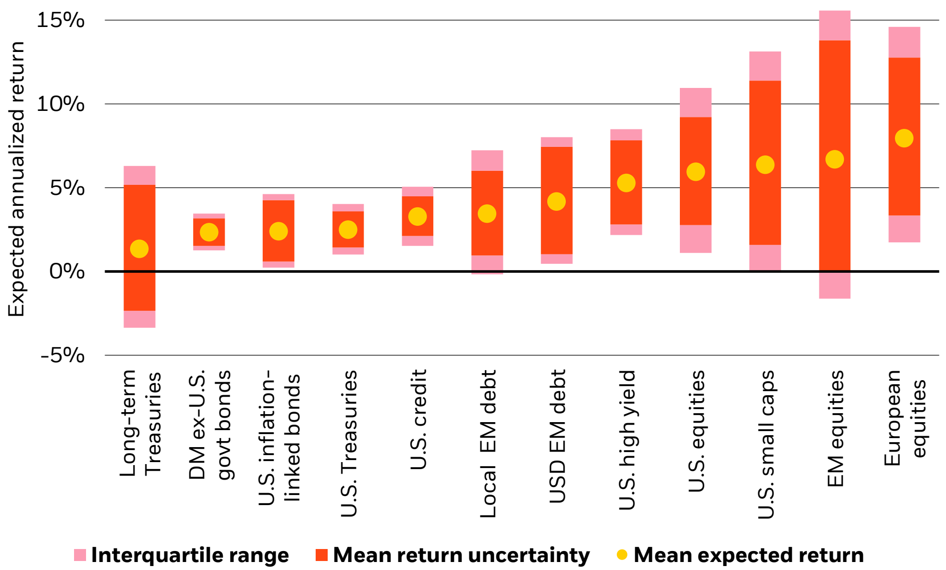
Themes

Raising resilience

Portfolio resilience is always crucial. Yet greater resilience is called for in a period of elevated macro uncertainty or at a vulnerable stage of the cycle. This is what we refer to as *conditional* resilience — conditional on how investors assess the current state of the markets. It is about taking a modestly defensive posture against concerns that currently are running higher than usual.

Returns and uncertainty

Expected U.S. dollar-based returns across asset classes on a 10-year horizon



This information is not intended as a recommendation to invest in any particular asset class or strategy. Forecasts are not a reliable indicator of future performance. Source: BlackRock Investment Institute, July 2019. Data as of February 28, 2019. Notes: The chart shows BlackRock's capital market assumptions (CMAs), or expected nominal returns across asset classes on a 10-year horizon, in U.S. dollar terms. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. See page 16 for a list of indices used. The bars represent the uncertainty around our mean return estimates. The lighter, larger bar is based on the 25th and 75th percentile of expected return outcomes – the interquartile range – of thousands of potential return pathways generated by a Monte Carlo simulation. The darker, smaller bar shows the distribution of values around BlackRock's mean expected returns. The difference in the size of mean return uncertainty between assets comes down to particularities of each asset class, including the ability to estimate returns and data availability. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Our market views (pages 12-15) reflect such a stance because of rising protectionism and geopolitical frictions. Lowering risk is one dimension of conditional resilience; seeking protection is the other. We believe government bonds play an important role in portfolios by serving as a buffer against selloffs of risk assets. We see them as crucial diversifiers. See page 9.

Unconditional resilience refers to investors acknowledging there is always fundamental uncertainty about long-term returns, irrespective of the stage of the economic or market cycle they believe they are in. Relying on historical data alone is not enough to inform views for strategic, or long-term, investing horizons, in our view.

Consider the different paths of two economies that looked very similar at the end of the 19th century: the U.S. and Argentina. With the benefit of hindsight, it's easy to suppose that the choice between them was obvious. But for investors at the time, armed only with what they had observed until then, it would not have been. Fundamental uncertainty is greater than what a look in the rear view mirror implies.

Risks tied to deglobalization and climate change — such as those detailed in Getting physical of April 2019 — represent such long-term uncertainty. This is why our approach to portfolio construction looks at multiple potential return pathways.

In a world where powerful long-term trends are playing out over decades, assuming certainty about average long-term returns seems problematic. We incorporate uncertainty in our long-term return expectations as a result. See the *Returns and uncertainty* chart.

The wider uncertainty bands, such as for U.S. small cap or EM equities, represent asset classes where we have lower conviction about our mean return estimates. An asset allocation process that incorporates such uncertainty results in a more diverse portfolio than typical approaches that assume long-run returns are known with precision, in our view.

Our bottom line: Embracing inherent uncertainty about the future is the cornerstone of our revamped approach to portfolio construction and our capital market assumptions – and fundamental to creating portfolio diversification.

Government bonds can play a key role in building portfolio resilience – tactically and strategically.

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Focus

Geopolitics

We see geopolitical risk as a material market factor in 2019. The market impact of geopolitical risks has historically tended to be more acute when economies are slowing, our research suggests. See Gauging geopolitics of June 2019 for details. The U.S. has become an exporter of geopolitical and economic uncertainty as the administration implements its "America First" approach. We believe this represents a transition away from the largely cooperative post-Cold War period to a more competitive international environment, with the return of Great Power politics.

Tough rhetoric from both the U.S. and China, tit-for-tat tariffs and tensions over U.S. restrictions on Chinese tech signal an economic conflict that will be difficult to meaningfully resolve — temporary trade truces notwithstanding. We see tensions between the U.S. and China as structural and long-lasting, with economic and security interests increasingly intertwined. Market attention to the *U.S.-China competition* risk on our Geopolitical risk dashboard has been rising, as the countries compete to dominate the industries of the future. See the *Rising up* chart.

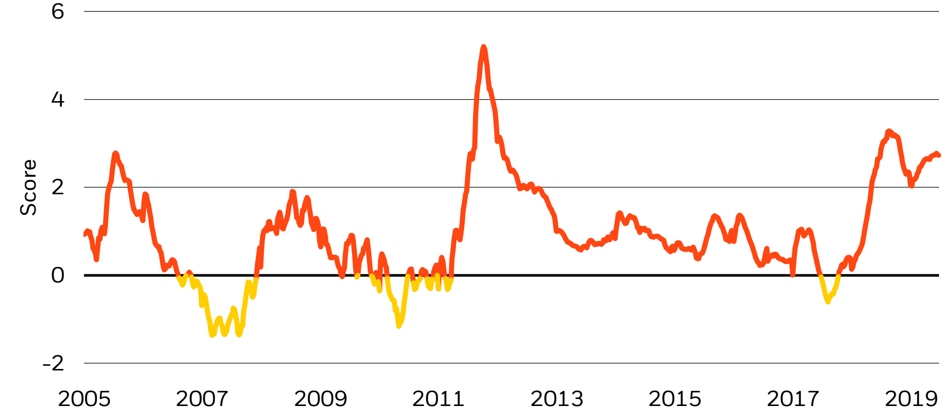
We see the U.S.-Mexico trade relationship as durable but believe the recent U.S. threat to impose tariffs on imports dims prospects for the passage of the revamped North America trade deal before the 2020 elections — and reduces incentives for other countries to negotiate trade agreements with the U.S. Global trade tensions could rise further if the U.S. implements tariffs on imported autos and parts from Europe or Japan — or resorts more often to tariffs to achieve political goals.

> "The U.S. has become an exporter of geopolitical and economic uncertainty as the administration implements its "America First" approach."
>
> **Tom Donilon**
>
> **Chairman, BlackRock Investment Institute**

Author

Rising up

BlackRock Geopolitical Risk Indicator for U.S.-China competition, 2005-2019



Source: BlackRock Investment Institute, with data from Refinitiv, July 2019. Notes: We identify specific words related to geopolitical risk in general and to our top-10 risks. We then use text analysis to calculate the frequency of their appearance in the Refinitiv 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. We recently improved the methodology of our global BGRI, tying it closely to our other risks and updating the keywords. The chart may look different from previous updates as a result. The BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Global trade is not the only geopolitical risk facing markets. In the Gulf, the U.S. has intensified its maximum pressure campaign against Iran, affecting both the Iranian economy and currency. We for now believe this is unlikely to spiral into general conflict, but worry that escalation on both sides has increased the risk of significant incidents.

Our indicators also point to heightened market attention to the risk of European fragmentation. The Oct. 31 deadline for Brexit is a risk on the horizon, and uncertainty over the long-term UK-European Union (EU) relationship is elevated. European parliamentary elections delivered a mixed result that saw anti-EU populist and other parties gain at the expense of mainstream ones. Another lingering risk: Tensions related to Italian budget talks are likely to bubble up in coming months.

Focus

China's economy

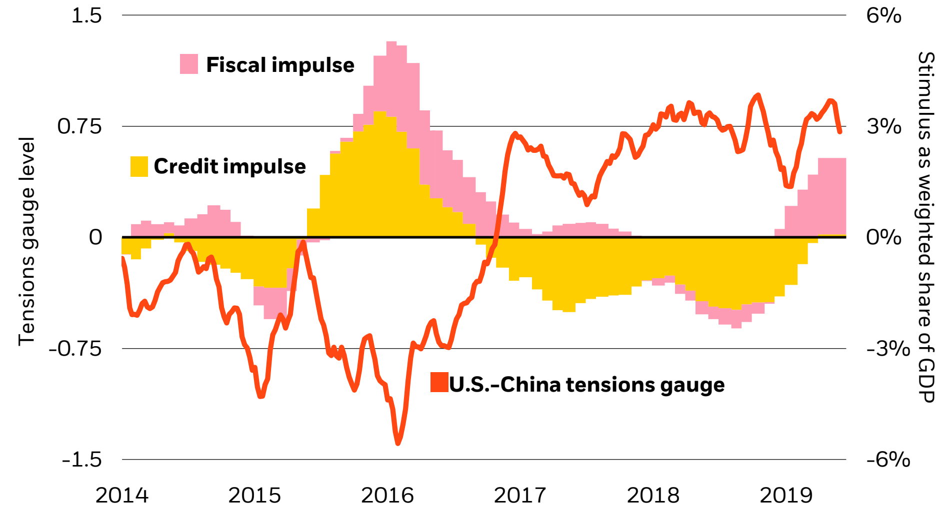
Economic activity in China has faltered on the back of an escalation in trade tensions, and we see limited near-term upside in growth. Policy stimulus is likely to help offset any trade shocks but not deliver a meaningful growth boost. Why? The fallout from the U.S.-China rivalry threatens a renewed downturn. Confidence in both the corporate and household sector is currently running low — one reason why the current recovery appears anemic, even after significant stimulus in late 2018. See the *Turning it around* chart.

We expect Chinese policymakers to revert to trusted tools such as infrastructure spending and other fiscal stimulus to counter the slowdown. We see significant monetary easing or a sharp currency depreciation as unlikely. This would run counter to Beijing's prime objective to maintain financial stability and prevent a rerun of the destabilizing capital outflows seen in 2015-2016.

How big could the trade shock get? Estimates of the net impact on economic growth vary and are often based on models that find it difficult to quantify the fallout of trade disruptions. This suggests risks could be skewed to the downside. The shake-up of longstanding supply chains could disrupt corporate spending plans, while a softer job market could pressure consumer spending.

Turning it around

China fiscal and monetary stimulus and trade tensions gauge, 2014-2019



Sources: BlackRock Investment Institute, National Bureau of Statistics of China and the People's Bank of China, with data from Refinitiv Datastream, July 2019. 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. We weight both the fiscal and credit impulse to reflect their respective contributions to GDP growth – as estimated in a December 2017 IMF paper. The trade tensions gauge measures the principal driver of U.S.- and China-sensitive financial instruments, including U.S. tech shares, the MSCI China, copper, USD/CNY, EM credit spreads and U.S. high-yield spreads. We strip out the influence of global growth (with our G7 Growth GPS) and market liquidity (U.S. interest rate volatility) to gain a measure of to what extent markets are pricing in U.S.-China tensions. The index is expressed as a z-score (five-week moving average), in standard deviations above or below the historical mean.

A more subdued outlook for Chinese growth could cut short the boost in activity we had expected for the rest of the world, particularly the eurozone and EMs. European manufacturing activity and capital spending are closely correlated with export orders from China, as we have previously shown.

The uncertain macro outlook keeps us broadly underweight Chinese and China-related assets in the short run (see pages 12-14). Yet we see the gradual opening up of China's onshore markets — and their increasing weight in global bond and equity indexes — as important sources of diverse returns for investors in the medium term. Consumer-oriented services such as advertising, healthcare, or insurance have room to grow and are now more accessible to foreign investors.

Authors

Elga Bartsch
Head of Macro Research
BlackRock Investment Institute

Ben Powell
Chief Asia-Pacific Strategist
BlackRock Investment Institute

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Focus

Coping with low yields

The plunge in bond yields, including 10-year German bunds trading at record low negative levels, is creating more challenges for investors in an already yield-starved world. About half of developed market bonds currently yields less than 1%, with more than a quarter in negative territory. See the *Sub-zero* chart. This raises questions about the role that government bonds play in a portfolio.

We believe government bonds retain a core role for their diversification benefits. Even at these low yields — and with lower prospective returns – government bonds can act as ballast. They help offset the impact of equity selloffs in an environment of rising macro uncertainty, we believe. That diversification benefit outweighs the yield pickup from credit — a view reflected in our long-term allocation preferences. Yet we also note that the cost of this protection is higher and the risk/reward trade-off is different on a near-term horizon. For that reason, we have downgraded U.S. Treasuries and are overall more positive on credit on a tactical basis. See pages 12 and 13 for details

We see more uncertainty about inflation in the medium term at a time when inflation expectations have plunged. The reasons are expansionary monetary and fiscal policies, combined with a possible gradual reversal of the globalization trends that have long kept a lid on prices. The latter is subject of internal debate at BlackRock. See page 10. All in all, we believe inflation-protected securities can play a more sizeable role within long-term government bond allocations.

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Expected correlations between key asset classes are the main driver of building resilient portfolios. It’s not just about returns.

Vivek Paul
Portfolio research, BlackRock Investment Institute

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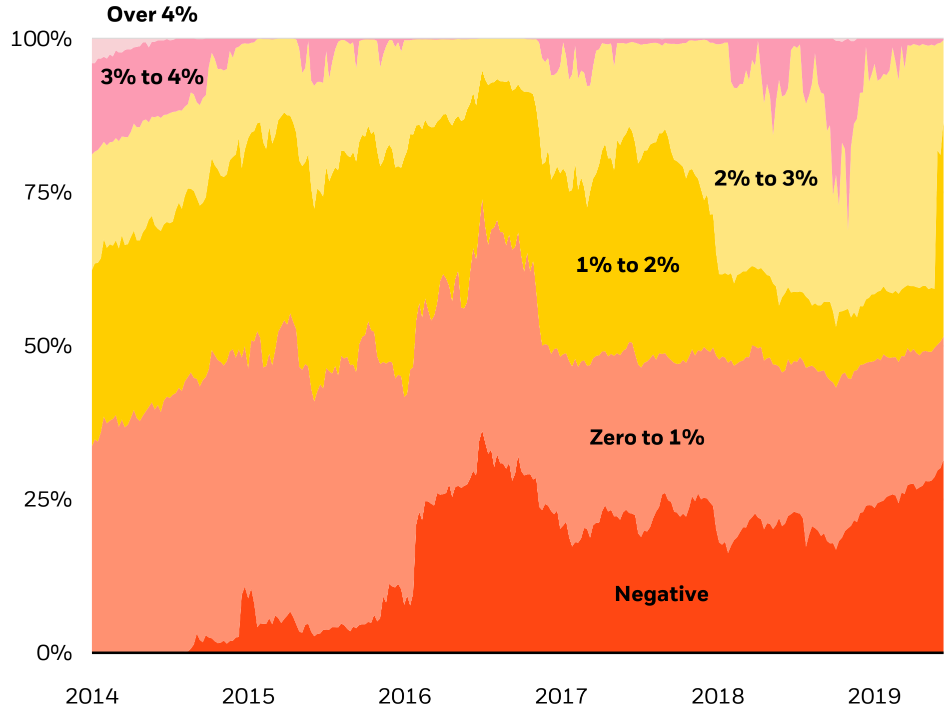
Author

Sub-zero

Developed market government bond yield distribution, 2014-2019



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from J.P. Morgan and Refinitiv Datastream, July 2019. Notes: The chart areas show the share of bonds by market value within the J.P. Morgan Global Developed Bond Index with yields in each range. Indexes are unmanaged. It is not possible to invest directly in an index.

U.S. Treasuries can provide diversification for long-term eurozone investors. The drop in German bund yields suggests that some eurozone government bond yields may be getting closer to an effective lower bound. This means they offer diminishing room for diversification, having less room to gain when equities slide. We view U.S. Treasuries as an alternative if eurozone rates fall further. This is about increasing diversification; not about capitalizing on higher yields as hedging costs for eurozone investors quickly wipe out any yield pickup. We again see the balance of risks tilted the other way in the short term and have upgraded eurozone sovereigns in light of imminent ECB easing (pages 12 ands 13).

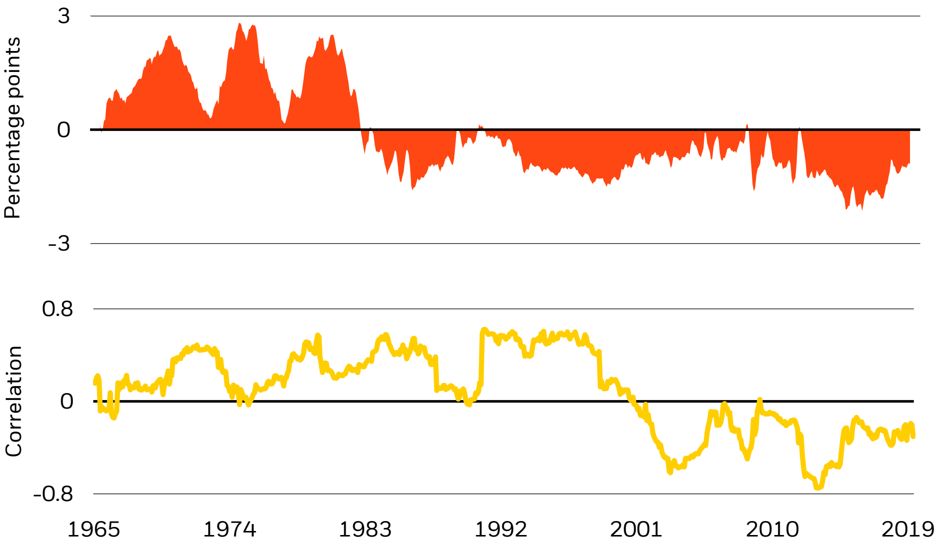
Forum debate

Inflation

Low inflation has been a hallmark of globalization as the world's productive capacity has increased rapidly. Investors have become used to a world where inflation is low and inflation surprises are almost always to the downside. Our gauge of inflation shocks in the top chart below shows how inflation has mostly come in below expectations since the 1980s. This has arisen in an environment largely devoid of negative macro supply shocks — such as the oil shocks of the 1970s — that push growth lower and inflation higher. And growth disappointments have tended to come with lower inflation — characteristic of demand shocks.

Lowflation regime

U.S. inflation shocks and the government bond-equity correlation, 1965-2019



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics, with data from Haver Analytics and Refinitiv Datastream, July 2019. Notes: The top chart shows We the difference between the actual and expected inflation outcomes. We use a statistical model to estimate inflation expectations back to 1965, drawing on the relationship between the actual U.S. Consumer Price Index (CPI), GDP and policy interest rates over trailing three-year periods. We use these regressions to estimate the expected annual inflation rate in three months' time. The bottom chart shows the correlation of the U.S. 10-year Treasury and the S&P 500 Index over rolling three-year periods based on monthly readings. A correlation reading of 1 suggests the two move in lockstep, and a reading of -1 suggests their movements are completely opposite.

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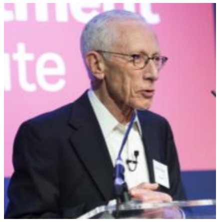
Long term, I don't see deglobalization as an inflation shock. It is more a price-level shock that's negative for growth.

Rupert Harrison

Head of Research, Diversified Strategies
BlackRock Multi-Asset Strategies



How does a U.S.-China trade war end? Both could declare victory, or it could lead to a cold war that destroys the benefits of globalization.

Stanley Fischer

Senior Advisor
BlackRock Investment Institute

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As a result, bonds have tended to cushion portfolios during equity selloffs in this period. The bottom chart shows the negative correlation between stock and bond returns has occurred during a period of low inflation. The risk? Trade protectionism and deglobalization could unwind some of these benefits over time and serve as a negative supply shock that raises prices, slows productivity growth and lowers economic output — an outcome investors haven't had to worry about for decades. This has important portfolio construction implications. It means that we could see periods of lower growth and higher inflation, pushing bond and equity returns lower. This would reduce the desirability of holding bonds in a portfolio to offset pullbacks in equities.

Not all of us are convinced. Another camp believes deglobalization will force a gradual realignment of global supply chains and the abandonment of manufacturing capacity, leading to disinflation. The debate shows there's much uncertainty around long-term inflation risks, even if we see them tilted upwards.

Repeated downside inflation surprises have convinced markets price pressures are a thing of the past. We believe risks to inflation are more two-way and could surprise on the upside, marking a regime change from recent decades.

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Forum debate

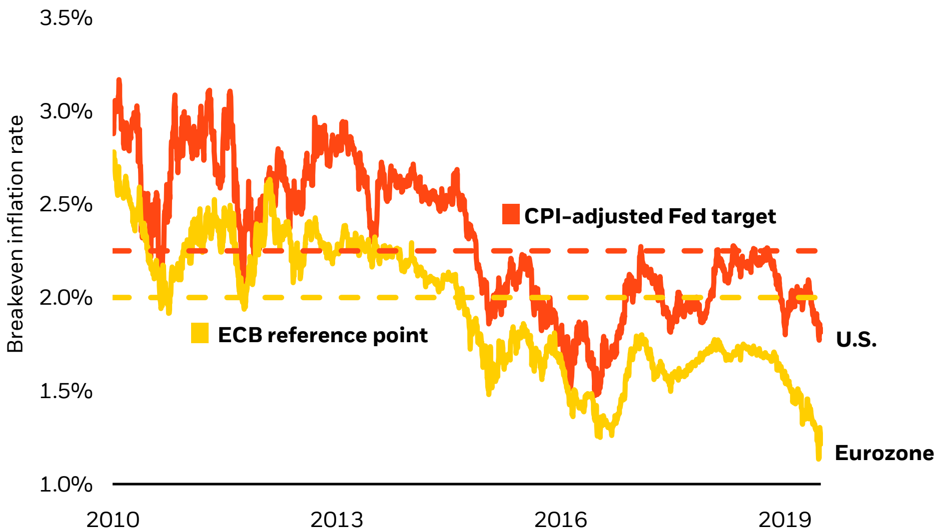
Central banks

Major central banks have made an important shift toward policy easing. ECB President Mario Draghi declared that the persistent stretch of low inflation in the post-crisis period means that more action is needed to reinforce the central bank's credibility in getting inflation higher. Draghi looks set to commit the central bank to more stimulus in his final months in office before a successor takes the reins in November. We expect ECB measures in the form of both deeper negative interest rates and more QE as a result.

The Fed now looks ready to trim rates as insurance against any slowdown. Yet we believe looser monetary policy may not be effective in dealing with the effects of protectionism and geopolitical tensions: Our take: Policy easing cannot offset a drop in potential growth due to a negative supply shock. With a recession unlikely, markets may be counting on too many Fed rate cuts and could be disappointed.

Inflation undershoot

U.S. and eurozone market-based inflation expectations, 2010-2019



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Bloomberg. July 2019. Notes: The chart shows the market pricing of inflation based on five-year forward inflation in five years' time, as measured in inflation swaps. The Fed target is adjusted 25 basis points higher to account for the difference in market pricing of the CPI index in inflation swaps relative to the PCE inflation index, the Fed's target. The ECB targets inflation just below a 2% reference point.

"The market is challenging the view that the ECB can bring up inflation. The contrarian view? The market may be too pessimistic.

Giulia Artolli

Portfolio Manager
BlackRock Fundamental Fixed Income – Europe

Does the vicious circle of low inflation and low inflation expectations call into question the efficacy of central bank tools? It's possible.

Bob Miller

Head of Fundamental Fixed Income – Americas
BlackRock"

Central banks are worried that inflation shortfalls are becoming too embedded in expectations, as seen in the *Inflation undershoot* chart. The Fed is openly debating — and the ECB is starting to embrace — "make-up" strategies that allow the economy to run hot for a while to compensate for previous inflation shortfalls. Yet make-up strategies require markets to have faith in central banks' ability to create inflation. Without this, it is unlikely that central banks would be able to engineer the sizeable swings in short-term inflation expectations that standard macro models predict would be needed for a swift economic recovery.

If central banks implement make-up strategies, Fed and academic models suggest economies would return more quickly to a steady state following a downturn. Interest rates would likely stay lower for longer than under the current policy frameworks. Macroeconomic volatility could decrease as the chances of a severe economic downturn diminish. But the risk of asset price bubbles could increase. See our June 2019 Macro and market perspectives for details.

Central banks are gearing up to provide stimulus to reach inflation targets and fend off a downturn. Yet looser monetary policies may not be the right cure for the afflictions of protectionism and geopolitical frictions.

BIIM0719U-892591-11/16

Market views

Investors today are challenged by powerful cross-currents. On the one hand, macro uncertainty is rising and asset prices have run up a lot this year. On the other hand, monetary policy has pivoted toward easing and valuations of many risk assets still look reasonable. The leads us to a modestly more defensive stance while still favoring risk assets with attractive risk/reward ratios.

What does this mean for our asset views? We favor reducing some overall equity risk, keeping government bonds as portfolio stabilizers and raising some cash for U.S. dollar-based investors.

We are overall more positive on credit markets, as the prospect of an elongated cycle bodes well for income-generating assets. This is balanced by downgrades of assets most exposed to China's economy or excessive market expectations of Fed easing. See the *In and out of favor* graphic for a summary of key changes to our 6-12 month asset views.

Within the overall slight reduction in equity risk, we maintain our overweight on U.S. equities amid reasonable valuations. The risk premium that investors demand on U.S. equities has steadily fallen yet is well above the levels seen in previous cycles. See the *Relative value* chart. Consider also that the dividend yield on the S&P 500 is comparable to the 10-year Treasury yield.

We have turned neutral on European equities, with ECB policy support likely to diminish downside risks. And we have downgraded our view on the equity markets most exposed to a lull in growth in China, including EM economies with the closest linkages.

We prefer long-term eurozone bonds over U.S. Treasuries despite negative yields in core markets such as Germany. We see markets pricing in too much U.S. easing and disinflation given still decent economic fundamentals and potential trade disruptions.

In contrast, we expect the ECB to meet — or even exceed — stimulus expectations. And U.S. dollar-based investors can potentially pick up an immediate yield boost after hedging euro-denominated exposures back into their home currency, because of the interest rate differential between the two regions. See page 13.

In and out of favor

Major changes to BII six- to 12-month asset views, July 2019

View change	Assets	Comments
▲ upgrades	EM debt; European equities, sovereigns and credit	Thirst for yield as global central banks pivot to easing, pressuring yields and extending the cycle; dovish European Central Bank supports the region's assets
downgrades ▼	EM and Japanese equities; U.S. Treasuries	Vulnerable to potential lull in Chinese growth; Federal Reserve to ease less than markets expect

Source: BlackRock Investment Institute, July 2019. Notes: The table shows major upgrades and downgrades to BlackRock Investment Institute's six- to 12-month asset views. See page 15 for full details of our asset views.

Relative value

U.S. equity risk premium, 1995-2019

Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2019. Notes: We calculate the equity risk premium based on our expectations for nominal interest rates and the S&P 500 earnings yield. We use our expectations for interest rates so the estimate is not influenced by the term premium in long-term bond yields.

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Fixed income

A dovish pivot by central banks and a slowing, but still growing global economy bode well for income-seeking investors, in our view. Credit market valuations look decent. Credit yields have fallen to the bottom of recent ranges, driven by the decline in government bond yields and tightening yield spreads. See the *Income wanted* chart. Yet spreads still leave some cushion against the risk of rising rates. Muted issuance is a positive. With the current upswing stretching out further, default risks connected to a downturn are also further away.

We have upgraded our view on EM debt, where the dovish shift in U.S. policy has provided support to local-currency markets. The high yield portion of the EM debt complex offers attractive spreads, in our view. And we believe local-currency EM debt has further room to run despite a recent rally, although we steer clear of countries with high exposure to U.S.-China trade tensions.

We see government bonds as key stabilizers against a backdrop of rising macro uncertainty. Yet we are neutral overall on duration — and are turning more cautious on U.S. Treasuries in the short run. Why? We believe market expectations of U.S. policy easing have gone too far. U.S. economic data outside manufacturing have been at trend. Another reason: We expect to see an uptick in U.S. inflation in the months ahead, as reflected in our Inflation GPS. Any additional tariffs would add to this risk. We see the Fed likely cutting rates as insurance against escalating trade conflicts, but failing to deliver on the four quarter-point rate cuts through 2020 that markets are currently pricing in. As a result, we believe investors today are not sufficiently compensated for duration risk in U.S. Treasuries.

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With geopolitical cross-currents and policy at the ready for easing, stability in yields is the base case for global fixed income for the quarter.

Scott Thiel
Chief Fixed Income Strategist
BlackRock Investment Institute

Author

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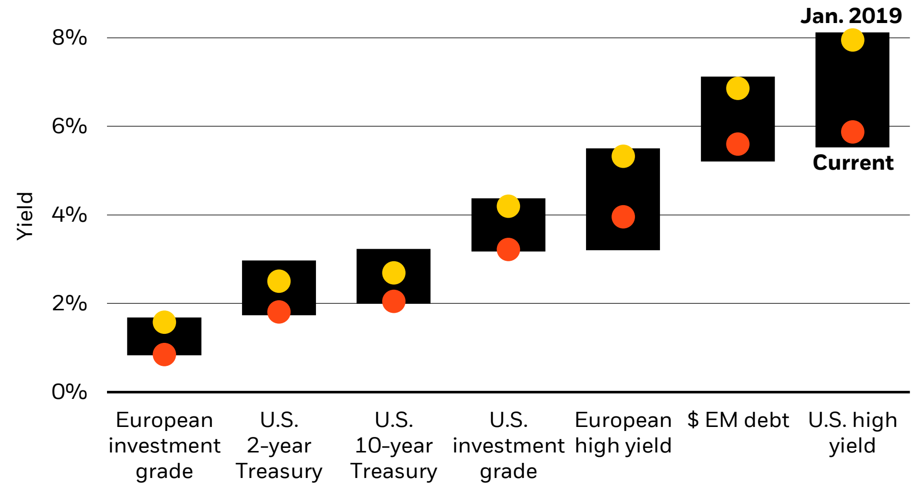
Income wanted

Yield ranges on various fixed income asset classes, 2018-2019



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, Bloomberg Barclays and J.P. Morgan, June 2019. The black bars show the range in yields for each index from the start of January 2018. Indices used: Bloomberg Barclays Pan-European Corporate, Refinitiv 2-year and 10-year benchmark U.S. Treasury, Bloomberg Barclays U.S. Corporate Investment Grade, Bloomberg Barclays Pan-European Corporate High Yield, Bloomberg Barclays U.S. Corporate High Yield and J.P. Morgan Emerging Market Bond Index Global Diversified. It is not possible to invest directly in an index.

In contrast, the eurozone has long been facing structural challenges in getting inflation back to target. We see a recent speech by ECB President Mario Draghi paving the way for further policy actions. The central bank's options include a change in forward guidance, taking rates even more negative and restarting asset purchases.

Negative rates are a challenge for eurozone investors, but a relatively steep yield curve is a plus for investors able to borrow at the short end and invest in the long end of the curve, capturing the yield differential. We also see attractive opportunities in credit for these investors because of the ECB's easing bias and the prospect of renewed purchases of corporate debt by the central bank.

European government bonds also present an opportunity for U.S.-dollar-based investors, despite their unattractive yields. The reason: Currency hedging dynamics, partly driven by the hefty U.S.-euro interest rate differential, mean U.S. investors may gain an attractive yield boost after hedging euro-denominated exposures back into dollars.

Equities

We maintain our positive view on equities, especially in the U.S., even as we favor moderately lower active risk in portfolios overall. Equities have historically performed well in the latter stages of the economic cycle — generating returns above the full-cycle average. See our Q2 Global Investment Outlook for details. And we see potential for this cycle to stretch further, with central banks willing to underwrite the expansion.

Yet rising macro uncertainty argues for a conservative approach. This is why we prefer equities in the U.S., where we find more companies with attractive growth prospects, free cash flow and solid balance sheets than in other developed markets. Valuations are richer than other major markets but still appear reasonable, with the price-to-cash flow yield of the S&P 500 Index roughly in line with its average since 1990.

We have turned negative on most EM equities because of our belief markets are pricing in too much Chinese stimulus. This points to downside risk in China, EM Asia and developed markets closely tied to China such as Japan. We do see selected EM opportunities in Latin American markets such as Brazil.

European equities are also exposed to any lull in Chinese growth as well as to trade disputes. Yet we see ECB easing more than offsetting these challenges, justifying our upgrade to neutral. A mildly expansionary fiscal stance in the eurozone — which has potential to become larger — is another support. Security selection is key as many index heavyweights are financials grappling with negative rates and consumer discretionary companies facing trade disruptions.

“ Low interest rates and low cost of capital mean you *should* pay up for growth, but I do worry how trade wars and supply chain disruptions could raise costs and decrease margins.

Tony DeSpirito

Director of Investments
BlackRock U.S. Fundamental Active Equity ”

Finding factors

BlackRock views on U.S. equity factors and their major drivers, July 2018

Factor	Economic Regime	Valuations	Dispersion	Relative Strength	Total
Min vol	++	– –		++	+
Momentum	– –	–		++	+
Value	– –	++		– –	–
Quality	+	–	– –	++	
Size	– –	+	++	– –	–

Sources: BlackRock Investment Institute and BlackRock's Factor-based Strategies Group, July 2019. Notes: The table shows our views on five major equity style factors: Minimum volatility (min vol), momentum, value, quality and size. See p.16 for definitions of each. We show four major drivers of our view on each. Economic regime refers to where we are in the business cycle. Valuation measures the cheapness or priciness of factors. Dispersion measures the opportunity set that factor strategies have in the current market. Relative strength measures how strong recent performance of the factor has been. Plus signs indicate overweight; minus underweight. Blanks indicate neutral.

We believe one useful way to view equity markets is through the lens of factors, or persistent drivers of returns. Investors can potentially benefit from exposure to all five major equity style factors for diversification, but returns can be enhanced by tilting, or adjusting these exposures through the cycle, in our view.

Of the five major style factors, we currently tilt toward minimum volatility (“min vol”) and momentum in the U.S. The min vol factor has historically performed well in periods of decelerating economic growth: the current economic regime. See the *Finding factors* table. We still like many companies with quality characteristics, including strong balance sheets and free cash flow. Yet we have moderated our view on the quality factor to neutral in the U.S. due to elevated valuations – and tilt more toward it in other markets such as Europe. We remain underweight the value factor, despite a long stretch of underperformance making valuations historically cheap. Value equities — the cheapest pocket of the market — have historically performed best in the economic cycle’s recovery phase.

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Assets in brief

Tactical views on selected assets from a U.S. dollar perspective, July 2019

▲ overweight — Neutral ▼ underweight

Asset class		View	Comments
Equities	U.S.	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like momentum and min-vol, but have turned neutral on quality due to elevated valuations.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead
Fixed income	U.S. government bonds	▼	We have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipal bonds	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver — or even exceed — stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We have upgraded EM bonds to overweight on their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities in Latin America and in countries not directly exposed to U.S.-China trade tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

Note: Views are from a U.S. dollar perspective as of July 2019 and are subject to change at any time due to changes in market or economic conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as research or investment advice regarding any specific fund, strategy or security.

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The **BlackRock Investment Institute (BII)** leverages the firm's expertise to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

Indices used on page 6: Long-term Treasuries - Bloomberg Barclays Treasury 10+ Year Treasury Index; DM ex-US government bonds - Bloomberg Barclays Global Aggregate Treasury Index ex US; US inflation-linked bonds - Bloomberg Barclays US Government Inflation-linked Bond Index; US Treasuries - Bloomberg Barclays US Treasury Index; US aggregate bonds - Bloomberg Barclays US Aggregate Index; US agency MBS - Bloomberg Barclays US MBS Index; US credit - Bloomberg Barclays US Credit Index; Local EM debt - JP Morgan GBI-EM Index; USD EM debt - JP Morgan EMBI Global Diversified Index; US high yield - Bloomberg Barclays US High Yield Index; US equities - MSCI USA Index; US small cap equities - MSCI USA Small Cap Index; EM equities - MSCI Emerging Markets Index; Europe equities - MSCI Europe Index.

Definitions of factors used on page 14: The MSCI USA Momentum Index (momentum), MSCI USA Minimum Volatility Index (min vol), MSCI USA Risk Weighted Index (size), MSCI USA Sector Neutral Quality Index (quality) and MSCI Enhanced Value Index (value).

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