

# BLACKROCK INVESTMENT INSTITUTE



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## WEEKLY COMMENTARY • APRIL 29, 2019

### Key points

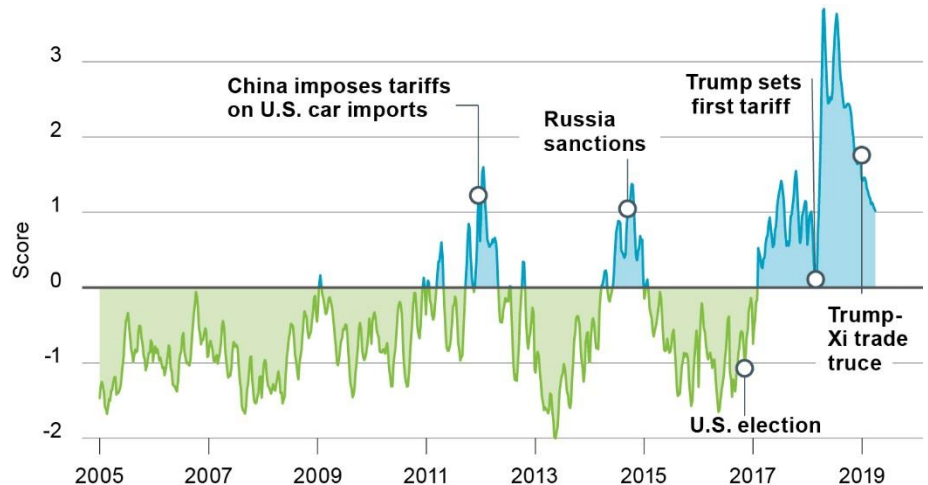
- 1 We expect Europe's economy to pick up pace in the second half of 2019. But trade tensions could be a risk to our base case.
- 2 First-quarter corporate earnings were encouraging. The U.S. economy grew faster than expected in the first quarter, but core inflation fell short.
- 3 The Federal Reserve is expected to keep its monetary policy unchanged. Its views on inflation will be a key market focus.

## 1 Trade troubles near Europe's shores

Europe's economy looks to be on the cusp of recovery – a potential support for the region's lagging risk assets. Yet there is a key risk to our base case: Trade tensions between the U.S. and Europe may heat up again. We would expect the direct economic fallout to be manageable, but it could have outsized market impacts.

### Chart of the week

BlackRock Geopolitical Risk Indicator for global trade tensions, 2005–2019



Sources: BlackRock Investment Institute, with data from Thomson Reuters, April 2019. Notes: We identify specific words related to this risk 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 market's attention to global trade tensions has dropped off from last summer's peaks. It now stands less than one standard deviation above the long-term average, as measured by our [BlackRock Geopolitical Risk Indicator](#), which scans analyst reports, financial press and tweets for keywords related to the risk. See the chart above. Our work shows that the potential market impact of a particular risk is typically larger when the market's attention to it is low. Market fears over trade tensions have calmed over recent months as the U.S. and China inch toward a trade deal. But we caution against focusing just on that. U.S. President Donald Trump appears keen to apply his "playbook" from U.S.-China negotiations – using tariffs as a key tool – to talks with the European Union (EU). European leaders have made clear that they would retaliate swiftly, and neither side is likely to back down in a hurry.

## A bumpy road ahead

We expect the European economy to [pick up pace](#) in the second half of 2019. Financial conditions have eased significantly since the start of the year, and China's stimulus efforts could boost capital spending – a potential boon for Europe's manufacturers. The pressure on growth from some one-off factors last year (such as Germany's auto production shortfalls) may be subsiding. An economic recovery would help underpin European stocks, a laggard in global markets for the majority of the post-crisis period. European stocks are trading at a 12% discount to developed market peers. But high-quality stocks including multinationals are trading at a premium to the rest of European market, while the structurally challenged sectors are at a discount.

Trade talks between the U.S. and EU are set to start, after the two parties had put a tariff tit-for-tat on hold in July 2018. The negotiation objectives laid out by the two sides have highlighted some key challenges. For example: Greater market access for agricultural products is a key focus for the U.S. – and explicitly excluded from the scope of the talks by the EU. Potential U.S. tariffs on Europe-made vehicles are another focus. The direct impact from any auto tariffs on Europe's growth would likely be contained, according to studies by the [IMF](#) and by the [European Central Bank](#) (ECB). Heated trade tensions between the two also would likely have global implications. We see the full impact on the European – and global – economies as potentially larger if trade tensions led to a hefty shock to confidence and a material tightening of financial conditions, as they did in 2018. If the growth outlook did worsen, we see European policymakers as having limited fire power to support the economy. The ECB has little room to further ease its monetary policy. And high debt levels mean many countries (except Germany) are already running out of headroom to deliver substantial fiscal stimulus.

Bottom line: Investors should not mistake a U.S.-China trade deal for a resolution of global trade tensions, as the U.S. is turning his focus to Europe. Political risks including trade tensions keep us cautious toward European risk assets, even as we see signs of green shoots emerging in the European economy. We prefer to take equity risk in other regions such as the U.S. and emerging markets.

## 2 Week in review

- First-quarter corporate results have been encouraging, based on reports from companies representing nearly a third of the global stock market value. Subdued expectations had lowered the bar for earnings beats. The tech sector's earnings were strong, while energy and materials sectors were the biggest drag, partly due to the impact of higher commodity prices from a year earlier.
- Chinese policymakers' attempt to temper expectations for more stimulus sent the Chinese stock market to its lowest in more than three weeks. The Bank of Japan stayed put on its monetary policy. Sweden's Riksbank and the Bank of Canada were the latest to join the ranks of dovish central banks. The U.S. Dollar Index hit the highest level since May 2017.
- The U.S. economy grew more than expected in the first quarter, mostly driven by a smaller trade deficit and greater inventory build-up. The rise in core personal consumption expenditures (PCE) prices, the Fed's preferred inflation gauge, fell short of consensus and sent U.S. Treasury yields lower. Germany's Ifo sentiment index fell short of expectations, adding to growth worries in Europe.

### Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	1.2%	18.0%	12.5%	2.0%
<b>U.S. Small Caps</b>	1.7%	18.5%	3.6%	1.6%
<b>Non-U.S. World</b>	-0.5%	13.1%	-2.3%	3.1%
<b>Non-U.S. Developed</b>	-0.1%	12.9%	-2.7%	3.3%
<b>Japan</b>	0.4%	8.2%	-6.8%	2.4%
<b>Emerging</b>	-1.3%	12.2%	-3.1%	2.7%
<b>Asia ex-Japan</b>	-1.4%	13.1%	-2.0%	2.5%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	0.3%	34.1%	-3.5%	\$72.15
<b>Gold</b>	0.9%	0.3%	-2.4%	\$1,286
<b>Copper</b>	-1.2%	7.3%	-8.1%	\$6,400

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	0.4%	1.8%	5.1%	2.5%
<b>U.S. TIPS</b>	0.6%	3.6%	3.7%	2.7%
<b>U.S. Investment Grade</b>	0.4%	5.7%	6.9%	3.6%
<b>U.S. High Yield</b>	0.2%	8.7%	6.7%	6.2%
<b>U.S. Municipals</b>	0.5%	3.2%	6.3%	2.3%
<b>Non-U.S. Developed</b>	-0.2%	0.6%	-2.8%	0.8%
<b>EM \$ Bonds</b>	0.0%	7.1%	5.7%	6.0%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	-0.9%	-2.8%	-7.9%	1.11
<b>USD/Yen</b>	-0.3%	1.8%	2.1%	111.60
<b>Pound/USD</b>	-0.6%	1.3%	-7.2%	1.29

**Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.** Source: Thomson Reuters. As of April 26, 2019. 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.

# 3 Week ahead

**April 29** U.S. March personal income and outlays

**May 1** Federal Open Market Committee meeting ends, U.S. manufacturing PMI

**April 30** China purchasing managers' index (PMI); eurozone Q1 gross domestic product (GDP); U.S.-China trade talks resume

**May 3** U.S. nonfarm payrolls, services PMI

Markets expect little policy change from the Fed's policy meeting this week. But Chairman Jerome Powell's comments on inflation during the press conference will be of great interest, given the recent moderate shortfalls in core inflation data. We still expect the Fed's next move on interest rates to ultimately be higher, but see the policy being on hold for some time. Markets expect the U.S. nonfarm payrolls number to slide from previous month – but still indicate a solid labor market.

## Asset class views

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

	Asset class	View	Comments
<b>Equities</b>	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. 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.
<b>Fixed income</b>	U.S. government bonds	—	We are cautious on U.S. Treasury valuations after the recent rally, but still see them as portfolio diversifiers given their negative correlation with equities. We expect a gradual steepening of the yield curve, driven by still-solid U.S. growth, a Fed willing to tolerate inflation overshoots — and a potential shift in the Fed's balance sheet toward shorter-term maturities. This supports two- to five-year maturities and inflation-protected securities.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	A still-growing economy, reduced macro volatility and a decline in issuance support credit markets. Conservative corporate behavior – including lower mergers and acquisitions volume and a focus on balance sheet strength – also help. We favor BBBs and prefer bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of easy ECB policy or pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. Yet any further deterioration in U.S.-European trade tensions could push yields lower.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich after a dramatic rally. We prefer high yield credits, supported by muted issuance and strong inflows.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia.
<b>Other</b>	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight \*Given the breadth of this category, we do not offer a consolidated view.

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