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BLACKROCK INVESTMENT INSTITUTE

Richard Turnill
Global Chief Investment Strategist

Richard Turnill is BlackRock's Global Chief Investment Strategist. He was previously Chief Investment Strategist for BlackRock's fixed income and active equity businesses, and has also led the Global Equity investment team. Richard started his career at the Bank of England.

Share your feedback at ***BlackRockInvestmentInstitute@blackrock.com***

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

Kate Moore
Chief Equity Strategist
BlackRock Investment Institute

Jeff Rosenberg
Chief Fixed Income Strategist
BlackRock Investment Institute

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WEEKLY COMMENTARY • SEPT. 24, 2018

Key points

1. We see reduced near-term risk of flare-ups over eurozone cohesion, but still see non-eurozone assets offering better risk-adjusted returns.
2. Global equities rose last week even as the U.S.-China trade conflict escalated. Value stocks rallied. The U.S. Treasury yield curve steepened.
3. The Fed is likely to raise rates this week and again in December, but its path in 2019 is less clear. Friday's inflation data could provide clues.

1 A check-in on European risk

Fears of a fiscal showdown between Italy's new government and the European Union (EU) have roiled Italian assets this year – and renewed concerns about EU cohesion. How worried are we? We see a limited risk of near-term flare-ups but are skeptical about the Italian government's commitment to fiscal discipline and Europe's ability to cope with the next downturn. We see better risk-return tradeoffs in non-EU assets.

Chart of the week

Italian and European equity and government bond performance, 2017-2018

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Thomson Reuters, September 2018. Notes: The green and light blue lines show the relative performance of the MSCI Italy Index vs. the MSCI Europe ex-UK Index, and the MSCI Europe ex-UK Index vs. the MSCI World Index. Equity performance is in total return terms, measured in local currency and rebased to 100 at the start of 2017. The dark blue line shows the yield of 10-year Italian government bonds over 10-year German bunds in percentage points.

Italian assets have taken a hit this year. The selloff was sparked by fears that Italy's populist government would breach the EU's key budget deficit limit of 3% of gross domestic product (GDP), as the two major parties in the new governing coalition had vowed to cut taxes and boost welfare spending in their campaign. Italian 10-year government bond yields spiked after the March election, while local stocks fell. See the chart above. Italian assets have recouped some losses recently, only after Rome repeatedly assured it would respect EU rules in its soon-to-be released budget. We see scope for a further recovery in Italian asset prices, but do not see them returning to pre-election levels anytime soon. Why? A number of structural factors are weighing down both Italian and European assets. This helps explain why European stocks have underperformed other global developed markets in 2018.

Our budget base case

All eyes are on Italy's 2019 budget, which will be viewed as a gauge of the country's needed commitment to fiscal responsibility. Our base case: The budget – to be announced this week and submitted to the European Commission by mid-October – is likely to be moderate enough to win EU approval. This should create some room for assets from Europe's periphery to rebound further. Yet structural issues bubble below the surface. A further deterioration in already weak Italian fundamentals – notably a debt-to-GDP burden above 130% and growth potential below 1% – would leave Italy vulnerable to a growth slowdown or external shock, though we see neither as imminent.

As for the region overall, the eurozone reform agenda is moving in the right direction. Yet we see the progress in motion as likely too small to make a meaningful difference when the next downturn hits. Prospects of a common insurance scheme for bank deposits across the region now appear all but dead, and the framework that would deal with the winding down of a failing European bank is murky. German leadership has been weakened as Chancellor Angela Merkel faces a popular backlash against her party's immigration policies. It is also crunch time for Brexit negotiations. We expect a deal, but the road to that outcome looks bumpy. Market attention toward the risk of European fragmentation stands only marginally above the long-term average, as our BlackRock geopolitical risk dashboard shows. This means negative surprises could incite a sharp market reaction. At the same time, a truce in trade tensions between the U.S. and the EU has helped relieve some pressure on European companies, especially automakers.

Bottom line: We see a low likelihood of a flashpoint between Italy and the EU in coming months, but we remain cautious on longer-term political and economic dynamics. European earnings growth lags other regions, and we prefer U.S. stocks as a result, as well as emerging market (EM) equities. Within European equities, our preferences include the industrials and health care sectors.

2 Week in review

- Global equities moved higher in a week characterized by a noteworthy change in market leadership toward value stocks. The materials and financials sectors outperformed, as did EM stocks, while more defensive sectors lagged. The U.S. Treasury curve steepened between two and 10 years as 10-year yields pushed above 3%.
- The U.S. announced tariffs of 10% on $200 billion of Chinese products, lower than the 25% tariff some investors had expected. The rate is set to increase to 25% in 2019. China responded with tariffs on $60 billion of U.S. goods but also hinted that it was considering broad-based tariff cuts on its global imports.
- Japan's Nikkei equity index hit a seven-month high. Manufacturing PMI data showed an expansion. The Bank of Japan maintained rates and its upbeat economic outlook. Prime Minister Shinzo Abe was re-elected leader of the ruling party.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.9%	9.6%	17.2%	1.8%
U.S. Small Caps	-0.5%	12.5%	20.1%	1.2%
Non-U.S. World	2.7%	-2.4%	2.2%	3.2%
Non-U.S. Developed	2.9%	-0.6%	4.1%	3.3%
Japan	3.8%	1.1%	10.4%	2.2%
Emerging	2.3%	-7.4%	-2.9%	2.9%
Asia ex-Japan	1.8%	-5.6%	-0.3%	2.7%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	-1.8%	-1.9%	3.1%
U.S. TIPS	-0.2%	-0.9%	0.2%	3.2%
U.S. Investment Grade	-0.2%	-2.5%	-1.2%	4.1%
U.S. High Yield	0.1%	2.4%	3.2%	6.3%
U.S. Municipals	-0.4%	-0.6%	-0.1%	2.9%
Non-U.S. Developed	0.3%	-2.0%	-1.1%	1.0%
EM $ Bonds	0.5%	-3.7%	-2.6%	6.5%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	0.9%	17.8%	39.6%	$78.80
Gold	0.4%	-7.9%	-7.1%	$1,200
Copper	6.5%	-12.2%	-1.4%	$6,363

Currencies	Week	YTD	12 Months	Level
Euro/USD	1.1%	-2.1%	-1.6%	1.17
USD/Yen	0.5%	-0.1%	0.1%	112.59
Pound/USD	0.0%	-3.3%	-3.7%	1.31

Source: Bloomberg. As of Sept. 21, 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

Sept. 24	First day of U.S. trading after many funds adjust positions in advance of S&P Global Industry Classification Standard (GICS) sector changes. A telecoms revamp is the key change.
Sept. 26	FOMC rate decision
Sept. 27	Eurozone economic sentiment; Germany Consumer Price Index
Sept. 28	China Caixin Manufacturing PMI; Japan industrial production; U.S. PCE price index; GICS framework officially shifts
Sept. 29	Deadline for Canada to join the revised U.S.-Mexico NAFTA deal
Sept. 30	China NBS Manufacturing PMI; U.S. government funding runs out

We see the Fed raising rates another quarter percentage point at its meeting this week and then likely again in December, against a backdrop of solid jobs growth and inflation. The rate path appears less clear in 2019 given the uncertain economic impact of trade conflicts, but we see potential for two to three rate hikes. The Fed's "dot-plot" rate projections, which will extend to 2021 this week, may provide some clues, in addition to the Fed's preferred measure of inflation, core PCE, to be released Friday.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Unmatched earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like momentum. We prefer quality over value amid steady global growth but rising uncertainty around the outlook. Financials and technology are our favored sectors.
	Europe	▼	Relatively muted earnings growth, weak economic momentum and political risks are challenges. Its value bias makes it less attractive absent a growth story. We prefer higher-quality, globally-oriented names.
	Japan	—	The market's value orientation is a challenge without a clear growth catalyst. Yen appreciation is another risk. Positives include shareholder-friendly corporate behavior, solid company earnings and support from Bank of Japan stock buying.
	EM	▲	Attractive valuations, along with a backdrop of economic reforms and robust earnings growth, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though a lot of it has been priced in. We see the greatest opportunities in EM Asia on the back of strong fundamentals.
	Asia ex-Japan	▲	The economic and earnings backdrop is encouraging, with near-term resilience in China despite slower credit growth. We like selected Southeast Asian markets but recognize a worse-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	▼	We see rates rising moderately amid economic expansion and Fed normalization. Longer maturities are vulnerable to yield curve steepening but should offer portfolio ballast amid any growth scares. We favor shorter-duration and inflation-linked debt as buffers against rising rates and inflation. We prefer 15-year mortgages over their 30-year counterparts and versus short-term corporates.
	U.S. municipals	—	Solid retail investor demand and muted supply are supportive, but rising rates could weigh on absolute performance. We prefer a neutral duration stance and up-in-quality bias in the near term. 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 favor investment grade (IG) credit as ballast to equity risk. Higher-quality floating rate debt and shorter maturities look 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. Valuations in the periphery appear tight. The exception is Italy, where spreads are reflecting simmering political risks. The upcoming end to the ECB's net asset purchases could dampen appetite for the asset class.
	European credit	▼	Increased issuance and political risks have widened spreads and created some value. Negative rates have crimped yields — but rate differentials make currency-hedged positions attractive for U.S.-dollar investors. We are cautious on subordinated financial debt despite cheaper valuations.
	EM debt	—	We prefer hard-currency over local-currency debt and developed market corporate bonds. Slowing supply and broadly strong EM fundamentals add to the relative appeal of hard-currency EM debt. Trade conflicts and a tightening of global financial conditions call for a selective approach.
	Asia fixed income	—	Stable fundamentals, cheapening valuations and slowing issuance are supportive. China's representation in the region's bond universe is rising. Higher-quality growth and a focus on financial sector reform are long-term positives, but a sharp China growth slowdown would be a challenge.
Other	Commodities and currencies	*	A healthy inventory balance underpins oil prices. Trade tensions add downside risk to industrial metal prices. We are neutral on the U.S. dollar. Rising global uncertainty and a widening U.S. yield differential with other economies provide support, but an elevated valuation may constrain further gains.

▲ Overweight — Neutral ▼ Underweight

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

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