BLACKROCK INVESTMENT INSTITUTE

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Key points

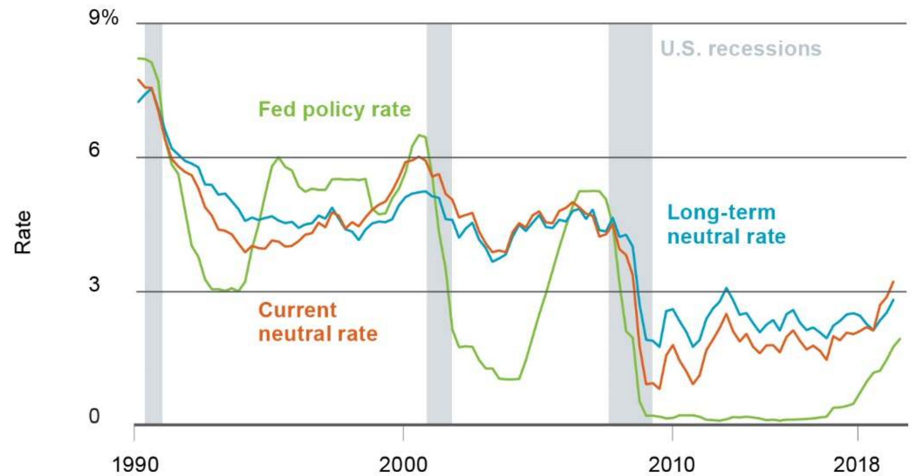
1. The Federal Reserve's policy rate is closing in on the "neutral" level. This could raise uncertainty around the Fed's future rate path, we believe.
2. Oil prices tumbled amid concern about demand weakness. Chinese equities outperformed developed markets as trade worries eased.
3. Markets are looking for signs of a rebound in the manufacturing data from key economies after October signaled a disappointing start to the quarter.

1 Our take on the "neutral" rate

A key input into the Fed's policy decision-making is its assessment of the "neutral" rate of interest – the rate at which monetary policy neither stimulates nor restricts growth. Our estimates show the Fed's policy rate is still below neutral – or slightly stimulative. Yet as neutral nears, new uncertainties on the Fed's rate outlook emerge.

Chart of the week

Fed policy rate and estimates of "neutral" rates, 1990-2018



Sources: BlackRock Investment Institute, with data from the Federal Reserve, NBER and Thomson Reuters, November 2018. Notes: The Fed policy rate refers to the federal funds rate, the central bank's short-term interest rate target. The estimates for the current and long-term neutral rates are calculated using an econometric model following a July 2018 ECB working paper *The natural rate of interest and the financial cycle*.

The federal funds rate sits below our estimate of the neutral level, but is closing in, according to analysis by our Economic & Market Research Team. The below-neutral policy rate suggests U.S. monetary policy should still be providing some stimulus to the economy, though this boost is much smaller than several years ago when the gap to neutral was much wider. We present two estimates of the neutral rate: long-term and current. The *long-term* neutral rate is considered the equilibrium level that would prevail if financial leverage followed its long-run trend. It is guided by factors including the trend pace of economic growth and long-term demand for savings. The *current* neutral level factors in the additional impact of the financial cycle. A sustained period of credit growth serves to push the current level of neutral up because higher interest rates are needed to stabilize the economy. Conversely, the current neutral rate falls in a period of persistent deleveraging.

Neutral and the financial cycle

The extent to which the current neutral rate deviates from its long-term equilibrium level over a financial cycle has important implications for monetary policy. In the depths of the financial crisis, depressed animal spirits and rapid private sector deleveraging pushed the current neutral rate below its long-term equilibrium level. In such an environment, the Fed had to cut its policy rate even further below the long-term neutral level. Over time, the wounds of the crisis have healed and the situation has reversed. The current period of sustained re-levering has pushed the neutral rate back up above its long-term level. This implies the Fed would have to "lean against the wind" and push rates higher in order to prevent overheating pressures from building up.

The closer the Fed gets to neutral, a milestone it has been pursuing gradually for nearly three years, the greater the uncertainty over the interest rate outlook. For one, there is inherent uncertainty around the Fed's assessment of "neutral" given that it is an unobservable metric that can only be estimated statistically. Fed Chairman Jerome Powell has signaled he prefers to place less emphasis on the neutral rate in Fed communication given the difficulty in pinning it down. The Federal Open Market Committee, the central bank's policy-setting group, may become increasingly cautious as it "feels" its way toward neutral.

The narrowing gap between the Fed policy rate and the neutral level, and the rising uncertainty likely to accompany it, has implications for financial markets. The policy rate is ultimately likely to settle at levels far below pre-crisis averages. Yet for the first time in a decade, markets would no longer be under the auspices of stimulative monetary policies. This shift toward tightening financial conditions presents a hurdle for risk assets, underscoring our call for building greater resilience into investment portfolios. This implies a focus on quality and liquidity. We favor stocks of companies with strong balance sheets, ample cash flow and a healthy earnings outlook, and we find these companies predominantly in the U.S. In fixed income, we prefer an up-in-quality bent in credit.

2 Week in review

- Oil prices plunged on demand weakness concerns and technical selling. Brent crude hit eight-month lows and WTI fell to the lowest in over a year. The International Energy Agency (IEA) and the Organization of the Petroleum Exporting Countries (OPEC) both warned of a surplus in the first half of 2019. OPEC and its partners are likely to deliver another round of output cuts.
- Tech and energy stocks led global equities down. Chinese equities bucked the trend, supported by easing trade worries on news the U.S. has put the next round of tariffs on hold. Record-smashing retail sales on China's "Singles Day" also lent some support.
- European Union and UK negotiators agreed on a draft Brexit deal. It is likely to be endorsed by EU leaders on Sunday, but passage by the UK parliament – and the survival of Theresa May's government – are in doubt. The German economy contracted in the third quarter for the first time since 2015, though a rebound is expected. Italy declined to modify its 2019 budget to meet EU rules.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-1.5%	2.3%	5.8%	2.0%
U.S. Small Caps	-1.4%	0.5%	4.1%	1.3%
Non-U.S. World	-0.7%	-10.2%	-7.2%	3.5%
Non-U.S. Developed	-1.4%	-9.3%	-6.2%	3.6%
Japan	-1.6%	-8.0%	-5.2%	2.4%
Emerging	1.0%	-13.0%	-10.2%	3.1%
Asia ex-Japan	1.4%	-13.2%	-11.5%	2.9%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.7%	-1.5%	-1.5%	3.1%
U.S. TIPS	0.7%	-1.8%	-1.1%	3.2%
U.S. Investment Grade	-0.2%	-3.7%	-2.6%	4.3%
U.S. High Yield	-1.3%	-0.1%	0.8%	7.2%
U.S. Municipals	0.4%	-0.7%	-0.4%	3.0%
Non-U.S. Developed	0.4%	-4.0%	-2.5%	1.0%
EM $ Bonds	-0.5%	-5.3%	-4.0%	6.9%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-4.9%	-0.2%	8.8%	$66.76
Gold	1.1%	-6.1%	-4.3%	$1,223
Copper	2.5%	-14.4%	-7.9%	$6,205

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.7%	-4.9%	-3.0%	1.14
USD/Yen	-0.9%	0.1%	-0.2%	112.83
Pound/USD	-1.1%	-5.0%	-2.7%	1.28

Source: Bloomberg. As of Nov. 16, 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

Nov. 20 U.S. housing starts

Nov. 21 U.S. durable goods, existing home sales; European Commission publishes opinion on Italy's revised budget

Nov. 23 Eurozone, Germany and U.S. Purchasing Managers' Index (PMI) reports

Nov. 25 European Union and the UK hold Brexit summit

Several major economies will release their PMI figures for November. Markets are looking for a clearer sign of economic growth in the fourth quarter after October data showed slower manufacturing activity in key regions such as China and the eurozone. A rebound is expected in the eurozone data as one-off factors, such as the third-quarter disruption in auto industry production, fade.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Solid corporate earnings and strong economic growth underpin our positive view. We still like the momentum factor, but have a growing preference for quality as the 2019 macro and earnings outlooks become more uncertain. Technology tops our list of favored sectors.
	Europe	▼	Relatively muted earnings growth, weak economic momentum and political risks are challenges. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see a weaker yen, solid corporate fundamentals and cheap valuations as supportive, but await a clear catalyst to propel sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	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	▼	Sustained growth, rising inflation and fiscal stimulus point to ongoing Fed normalization. We still prefer the short end, but longer maturities are starting to look more attractive as we see limited further upside for rates. We see improved valuations on inflation-linked debt adding to its appeal. We find reasonable longer-term value in mortgages, but see short-term challenges as the Fed winds down its mortgage holdings.
	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. We believe higher-quality floating rate debt and shorter maturities look well positioned for rising rates.
	European sovereigns	▼	Yields are unattractive relative to global peers and vulnerable to the potential of an improving growth outlook. We see core eurozone sovereigns as ballast against ongoing political risks. Peripheral spreads reflect quite a bit of risk. Rising rate differentials have made high-quality European sovereigns more appealing for global investors with currency hedges.
	European credit	—	Valuations are attractive, particularly on a hedged basis for U.S. dollar investors. We favor subordinated financial debt, where yields are more attractive. We also prefer European over UK credit as the market is not pricing in a significant Brexit premium. Industrials and financials are favored sectors. Political uncertainty is a concern.
	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 reversal of recent oversupply is likely to underpin 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.BII1118U/E-661204-2068246

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