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

BLACKROCK®

WEEKLY COMMENTARY • OCT. 15, 2018

Key points

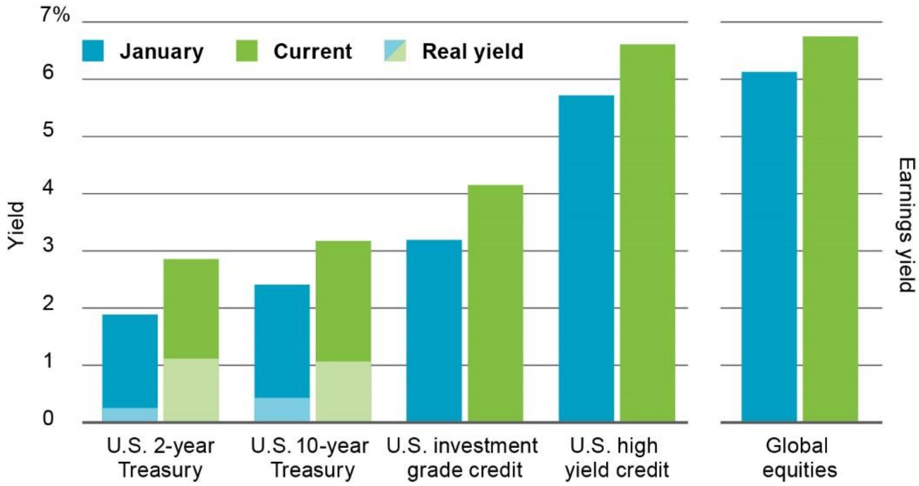
1. We maintain our preference for equities over fixed income but reiterate the need to focus on portfolio resilience amid increasing uncertainty.
2. Stocks fell, led down by growth and momentum shares. The VIX volatility gauge hit its highest since February. Quarterly earnings season began.
3. Third-quarter earnings reports and corporate guidance should shed some light on how tariffs may impact business sentiment and global growth.

1 October's selloff scares in context

Tighter financial conditions and elevated worries about the impact of heightened U.S.-China trade tensions are spooking investors – and have helped spark this month's equity pullback. We retain a preference for selective risk-taking, even as the recent market moves reinforce our call for building greater resilience into portfolios.

Chart of the week

Asset yield comparison, January vs. October 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, October 2018. Notes: Indexes used from left to right are: Thomson Reuters Datastream 2-year and 10-year U.S. Government Benchmark Indexes, Bloomberg Barclays U.S. Credit Index, Bloomberg Barclays U.S. High Yield Index and MSCI All-Country World Index. Yield in the equity market is represented by the 12-month forward earnings yield. Real bond yields are based on U.S. Treasury Inflation-Protected Securities (TIPS) yields. January yields are as of Jan. 1, 2018, and current yields are as of Oct. 10, 2018.

Higher interest rates are one of the key contributors to tighter financial conditions this year. Market expectations for future Federal Reserve rate hikes have adjusted upward and are now consistent with our outlook for around three rate rises over the next 12 months. The result: Higher yields on short-term bonds making for greater competition for capital. This is contributing to falling equity prices – mirrored by rising earnings yields – and rising bond yields. The recent move higher in bond yields has been driven by higher real rates – not inflation expectations. See the light blue and green shaded areas in the chart above. A rise in the term premium, the additional return investors demand for holding longer-term debt, has contributed. Investors have reset their return requirements across asset classes, given heightened uncertainty and rising short-term yields. This repricing has escalated since the start of October.

Fortifying portfolios

Part of the recent equity market drop was due to jitters about an intensification of the U.S.-China trade conflict. Some global companies cited trade concerns last week, fueling investor uncertainty about the sustainability of the growth and earnings outlook. Our gauge of overall geopolitical risk has dipped in the past few weeks, but U.S.-China trade tensions are high and we see trade tensions as the biggest global threat to the U.S.-led expansion. Our BlackRock GPS growth indicators point to robust global growth with low inflation – and do not show trade tensions hampering economic activity. However, the negative threat posed by trade protectionism could yet feed through due to highly globally integrated corporate value chains. Third-quarter earnings season will be key to watch in this respect.

Last week's decline in the MSCI World Index was the index's second-largest weekly drop in 2018, although global equities remain in positive territory year-to-date. Equity markets have seen a sharp rotation in leadership, with momentum shares underperforming after a stretch of strong gains. We believe the bulk of the recent selling pressure has been driven by hedge funds unwinding popular crowded positions – especially in technology and growth names. The rise in 10-year U.S. Treasury yields at the start of last week came after Fed officials' hawkish commentary pushed up market expectations for the path of U.S. policy rates. The rise in market yields has been driven by higher real rates and a higher term premium, often associated with increased uncertainty.

We still see corporate earnings supported by sustained above-trend global growth, and retain our preference for equities over fixed income. But we reiterate our call to focus on portfolio resilience. Companies that disappoint on third-quarter earnings and fourth-quarter guidance risk being acutely punished. We like quality exposures within equities and prefer the U.S. within developed markets due to earnings resilience and stronger balance sheets. In fixed income, we favor short-end bonds but are starting to see opportunities further out on the yield curve in the U.S. and Europe. Over the long term, the rise in yields should eventually point to higher returns across asset classes. Yet we see good reasons why risks will stay elevated or increase further in the short term, pressuring returns.

2 Week in review

- October's selloff across equities continued. The VIX hit 28.8, its highest level since February 2018. The S&P 500 notched its largest one-day drop in eight months on Wednesday, with the technology sector leading declines. U.S. 10-year Treasury yields climbed to seven-year highs before falling back. Brent oil prices fell.
- The U.S. core (ex-food and energy) Consumer Price Index (CPI) rose slightly less than expected in September. Shelter inflation (core CPI's biggest component) started to show weakness and bears close watching.
- Profit warnings from some global companies citing concerns over Chinese demand cast a cloud over third-quarter reporting season. Trade negotiations between U.S. and Chinese representatives ended without progress in Beijing. China's central bank announced its fourth rate cut this year, and China's yuan weakened versus the U.S. dollar.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-4.1%	3.5%	8.5%	2.0%
U.S. Small Caps	-5.2%	1.7%	4.1%	1.3%
Non-U.S. World	-3.5%	-9.1%	-6.1%	3.4%
Non-U.S. Developed	-3.9%	-7.5%	-4.7%	3.6%
Japan	-3.7%	-3.5%	2.8%	2.3%
Emerging	-2.0%	-13.6%	-10.5%	3.1%
Asia ex-Japan	-3.0%	-13.8%	-10.2%	2.9%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.5%	-2.0%	-2.0%	3.2%
U.S. TIPS	0.2%	-1.6%	-0.8%	3.2%
U.S. Investment Grade	0.4%	-3.0%	-2.2%	4.2%
U.S. High Yield	-0.5%	1.7%	1.9%	6.6%
U.S. Municipals	-0.2%	-1.2%	-0.7%	3.0%
Non-U.S. Developed	0.7%	-3.4%	-1.9%	1.1%
EM $ Bonds	-0.1%	-4.4%	-3.6%	6.7%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-4.4%	20.3%	43.0%	$80.43
Gold	1.1%	-6.6%	-5.9%	$1,217
Copper	2.1%	-13.0%	-8.5%	$6,302

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.3%	-3.7%	-2.3%	1.16
USD/Yen	-1.3%	-0.4%	-0.1%	112.21
Pound/USD	0.3%	-2.7%	-0.8%	1.32

Source: Bloomberg. As of Oct. 12, 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

Oct. 16	China Producer Price Index, CPI; Germany ZEW Economic Sentiment Index; U.S. industrial production, capacity utilization	**Oct. 18**	European Council meeting (potential update on Brexit)
Oct. 17	FOMC minutes	**Oct. 19**	China Q3 gross domestic product (GDP), industrial production, retail sales, fixed asset investment; Japan CPI

Third-quarter earnings season is here, with 75% of the S&P 500, 59% of the STOXX 600, and 50% of TOPIX market caps set to report results over the next three weeks. Analysts overall haven't lowered their earnings expectations, even as some global companies issued profit warnings last week citing higher input costs, rising wages, trade tensions and/or softer Chinese demand. A strong U.S. consumer and tight U.S. labor market still provide a supportive backdrop for results. Earnings reports and corporate guidance should provide more color on how tariffs might impact business sentiment and global growth. China's GDP data will also be in focus: Economists expect China's growth to gradually soften, but any downward surprise could further weigh on sentiment as we enter earnings season.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Strong earnings momentum, corporate tax cuts and fiscal stimulus underpin our positive view. We like the momentum factor and see a role for quality exposures amid steady global growth but rising uncertainty around the outlook. 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 earnings 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	▼	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. We believe 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	▼	Wider spreads have created value, yet a defensive stance is warranted amid heightened political risks. 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.
	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	*	Global supply constraints are 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.BII1018U/E-630026-1951309

BlackRock Investment Institute

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers; originates economic, markets and portfolio construction research; and publishes investment insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.

BII1018U/E-630026-1951309