BLACKROCK INVESTMENT INSTITUTE

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Key points

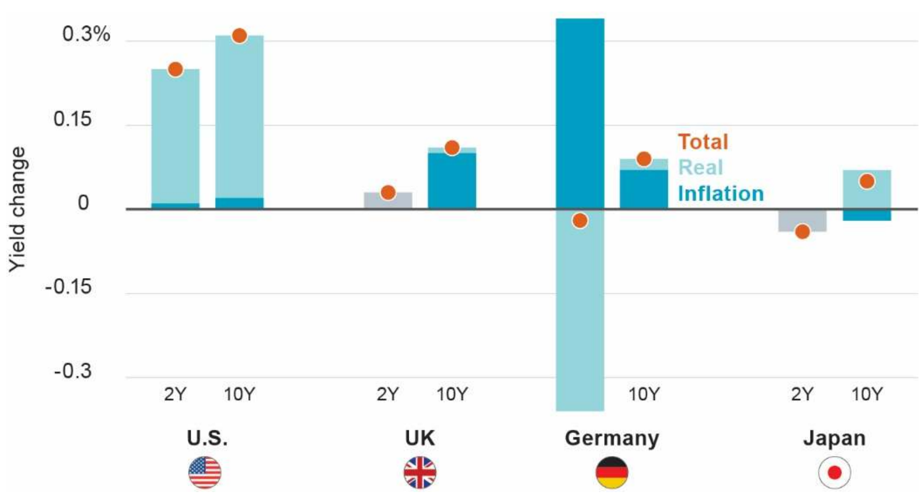
1. We maintain our preference for short-term bonds even after the rise in long-term yields.
2. Global equity markets stabilized after last week's selloff. The Italy versus Germany government bond yield spread hit the widest in over five years.
3. This week marks the peak of third-quarter earnings season in the U.S. The impact of trade conflict and a stronger dollar will be in focus.

1 Sticking to the short end (for now)

Long-term U.S. Treasuries have led a global government bond selloff over the past few months. Is it time to add exposure to longer-term bonds, as prices have fallen and yields risen? Not yet, we think. We see reasons to stick with shorter-dated bonds for now, even as some opportunities arise in intermediate- and long-term debt.

Chart of the week

Changes in government bond yields, August to October 2018



Sources: BlackRock Investment Institute, with data from Bloomberg, October 2018. Notes: The bars show the changes in yield for 2-year (2Y) and 10-year (10Y) benchmark government bonds from Aug. 31 (before the U.S. bond sell-off) to Oct. 18, 2018 in percentage points. We break down the 10-year yield change to change in real yields (nominal yields minus inflation) and that in inflation (represented by the yield on the equivalent inflation-linked bond). The breakdown is not shown on 2-year UK and Japan yields due to a lack of data.

What is driving the rise in bond yields? We break down the changes in yields in recent months in four key developed economies into their underlying drivers. What we found: Rising real yields (nominal yields minus the rate of inflation, in light blue) have contributed to the bulk of increases in the U.S. and Japan; rising inflation expectations (in dark blue) have been the main driver of yield changes in Germany and the UK. Real yields typically rise on firming growth expectations. To be sure, our BlackRock GPS suggests that consensus estimates for U.S. growth may be too low. The market is adjusting to the Federal Reserve's recent rhetoric suggesting a potentially higher terminal federal funds rate (the peak Fed rate in this hiking cycle).

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Our rate outlook

The market is pricing in about three Fed rate increases over the next 12 months, in line with our view. Changes in rate expectations are typically reflected in short-term government bond yields. Yet the front end of the U.S. yield curve has already priced in a reasonable amount of Fed tightening. Rising rate expectations are now lifting yields on the long end of the curve as terminal rate assumptions adjust higher. The growing U.S. budget deficit will lead to greater Treasury supply, potentially putting further upward pressure on yields. Even as real yields and the term premium (the compensation for owning longer-dated bonds relative to shorter-dated ones) have risen, investors in longer-dated bonds aren't yet being adequately compensated, in our view. The 10-year term premium is close to zero or even negative by some measures. We expect a further modest rise in the U.S. 10-year yield toward the top of a 3%-3.5% range – but not much further – over the next six months, as the market weighs Fed actions and the impact of U.S. fiscal stimulus. Yet any growth scares could spark demand for perceived safe havens such as U.S. Treasuries and weigh on yields.

We still prefer shorter-term sovereign bond exposures globally for now. The relatively flat yield curve in U.S. Treasuries presents an asymmetric risk-and-reward dynamic: Short-term U.S. Treasuries today provide 90% of the yield earned on long-term ones, with far less exposure to the risks associated with holding the latter. They also offer potential price upside if the Fed pauses on its normalization path. Yield curves in Europe and Japan are somewhat steeper than in the U.S., yet we still generally prefer the short end because central banks in those countries have yet to start normalizing their monetary policies.

Bottom line: We believe it is too soon to add significant exposure to longer-term global government bonds other than in selected areas such as longer-term tax-exempt U.S. municipal bonds. Currency dynamics are making European bonds more appealing for global investors despite their low headline yields. Conversely, higher U.S. yields are largely wiped out by the cost of hedging for euro- or yen-based investors, making domestic fixed income look more attractive. Overall we still see scope for long-term yields to rise in all regions.

2 Week in review

- Equity markets stabilized after last week's selloff. Emerging market mutual funds and exchange-traded funds saw the largest weekly inflows since April. Italian government bonds and bank shares sold off on the escalating budget row between Italy and the European Commission. Italian/German bond yield spreads rose to five-year highs.
- U.S. financial companies mostly reported better-than-expected profits and revenues for the third quarter. Insurance companies posted robust headline earnings, partly coming from a low base a year earlier. Analysts started shaving their forecasts for auto company earnings on escalating trade conflicts.
- China's lending and activity data suggested resilient economic growth that may soon benefit from policy support. U.S. job openings hit a record high, reflecting a tightening labor market.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.0%	3.5%	8.0%	2.0%
U.S. Small Caps	-0.3%	1.4%	4.0%	1.3%
Non-U.S. World	-0.3%	-9.3%	-6.7%	3.4%
Non-U.S. Developed	-0.1%	-7.6%	-5.3%	3.6%
Japan	-0.8%	-4.3%	0.1%	2.3%
Emerging	-0.9%	-14.4%	-10.9%	3.1%
Asia ex-Japan	-1.1%	-14.8%	-10.9%	3.0%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	-2.4%	-2.4%	3.2%
U.S. TIPS	-0.5%	-2.1%	-1.0%	3.3%
U.S. Investment Grade	-0.5%	-3.5%	-2.8%	4.3%
U.S. High Yield	-0.1%	1.6%	1.6%	6.6%
U.S. Municipals	0.1%	-1.1%	-1.0%	3.0%
Non-U.S. Developed	-0.3%	-3.7%	-2.5%	1.1%
EM $ Bonds	-0.2%	-4.5%	-4.0%	6.7%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-0.8%	19.3%	39.4%	$79.78
Gold	0.8%	-5.9%	-4.9%	$1,226
Copper	-1.3%	-14.2%	-10.7%	$6,220

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.4%	-4.1%	-2.9%	1.15
USD/Yen	0.3%	-0.1%	0.0%	112.55
Pound/USD	-0.6%	-3.2%	-0.6%	1.31

Source: Bloomberg. As of Oct. 19, 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. 24 Japan Nikkei manufacturing purchasing managers' index (PMI); eurozone and U.S. composite PMI; Fed beige book

Oct. 25 European Central Bank (ECB) monetary policy meeting

Oct. 26 U.S. advance third-quarter gross domestic product (GDP), personal income and outlays

Oct. 28 Brazil's presidential election (second round); Germany's Hesse state holds elections

This week will mark the peak of third-quarter earnings season in the U.S., with companies representing 36% of the market capitalization of the S&P 500 Index expected to report. Consumer discretionary, health care, industrials, tech and communications are in the limelight. A large number of European companies are also due to release earnings. Analysts will closely monitor the sturdiness of tech companies' supply chains amid concerns about trade tensions and the strength of Chinese demand. The rise in the U.S. dollar year to date could pose a risk to the earnings of U.S. exporters.

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 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	▼	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	—	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	*	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-634223-1973198

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