BLACKROCK INVESTMENT INSTITUTE

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Key points

1 U.S. midterm elections this week could result in a shift in the balance of power in Washington, but are unlikely to bring any near-term policy shifts.

2 Global equities took a breather after last week's selloff, but Mexican assets suffered after the president-elect scrapped a major airport project.

3 The Federal Reserve is expected to keep rates unchanged this week, but pave the way for another rate hike in December.

1 What U.S. midterms mean for markets

U.S. voters head to the polls this week for midterm elections that could bring two-party control of Congress – with implications for the future of key policies such as tax cuts. The elections add to the growing list of uncertainties markets are already grappling with, such as the impact of rising U.S.-China tensions.

Chart of the week

Estimated macro drivers of U.S. equity performance, 2016-2018

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, November 2018. Notes: The line shows the cumulative return of the S&P 500 Index since July 2016. Returns are broken down into the "growth effect" and "uncertainty effect". Co-movements in U.S. real yields and equities are interpreted as the market pricing in a change in growth expectations – the growth effect. The non-growth change is the uncertainty effect. We draw on the methodology used in the 2014 IMF paper *News and Monetary Shocks at a High Frequency: A Simple Approach*.

The U.S. equity market has been feeling jittery. We divide the drivers of U.S. stock returns into growth and non-growth varieties. The latter, a proxy for uncertainty, likely reflects rising concerns over the impact of trade conflicts and the sustainability of strong corporate earnings – and possibly political uncertainty ahead of the midterms. We see rising uncertainty, rather than concerns about growth and interest rates, as the main drag on the equity market lately. The midterms could spark some near-term market volatility, but we see other drivers as more important over the longer term. We view global trade tensions as a chief driver, and the greatest downside risk to the global expansion. De-escalation of such tensions would cheer risk assets such as equities. A likely meeting between U.S. President Donald Trump and Chinese leader Xi Jinping later this month will be a key signpost of whether tensions are set to ease – or heat up further in 2019.

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Scenarios

Polls and prediction markets suggest the most likely outcome of Tuesday's vote is that Democrats take over the House of Representatives and Republicans retain control of the Senate. We see this scenario having few market implications for now, given the low risk of rollbacks to the administration's tax cuts and regulatory policies in the short term. A divided Congress means policy stasis and has historically tended to benefit equities, but we see potential disruptors: U.S.-China tensions, given bipartisan support for cracking down on China's trade and intellectual property practices; and increasing partisan confrontation as the Democrats have vowed to use their oversight powers to investigate Trump's business practices and a host of other issues .

A less likely scenario, according to polls, is that Republicans retain control of both chambers of Congress. This outcome may have the biggest impact on the fixed income market. A Republican-led Congress could introduce more tax cuts, leading to higher budget deficits, more issuance of U.S. Treasuries – and potentially higher bond yields. Republicans may seek to extend the life of individual tax cuts and try again to repeal the Affordable Care Act. This scenario could provide the clearest path to the approval of "NAFTA 2.0". Democrats winning both chambers would be the greatest surprise for markets. Such an outcome likely would bring heightened concerns that earnings-boosting corporate tax cuts may be wound back in a future administration. In any scenario, neither party would likely command the 60 votes needed to enact most legislation in the Senate, pointing to gridlock.

Bottom line: We see few sustained market implications if the midterms result in a divided Congress. Our base case sees strong U.S. growth underpinning the global expansion, yet the range of possible economic outcomes is widening with a skew to the downside. We remain pro-risk, but advocate building greater resilience into portfolios. We favor quality companies, especially those with strong balance sheets, and find those predominantly in the U.S.

2 Week in review

- Equity market sentiment improved after the October selloff, boosted by news of a Trump-Xi conversation. The 30-year U.S. bond yield hit a 2018 high as the yield curve steepened. Mexican assets weakened as President-elect Andrés Manuel López Obrador unexpectedly scrapped an already-started, $13 billion airport project.
- Strong U.S. employment data looked to pave the way for the Fed to further raise interest rates in December. Job growth in October beat expectations, and wages recorded the largest annual gain in more than nine years.
- German Chancellor Angela Merkel decided not to seek re-election as head of her Christian Democratic Union party in December, unleashing renewed political uncertainty. Italy posted zero growth for the third quarter, triggering volatility in the Italy/German yield spread. The U.S. agreed to allow eight jurisdictions to buy Iranian oil despite sanctions.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.4%	1.8%	5.6%	2.0%
U.S. Small Caps	4.3%	1.8%	4.8%	1.3%
Non-U.S. World	3.9%	-9.2%	-7.0%	3.4%
Non-U.S. Developed	3.4%	-8.2%	-6.3%	3.6%
Japan	2.3%	-6.5%	-4.6%	2.4%
Emerging	6.1%	-12.1%	-9.4%	3.0%
Asia ex-Japan	6.7%	-12.4%	-10.3%	2.9%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.7%	-2.4%	-2.4%	3.2%
U.S. TIPS	-1.0%	-2.7%	-1.9%	3.3%
U.S. Investment Grade	-0.8%	-4.0%	-3.4%	4.3%
U.S. High Yield	0.2%	1.1%	1.2%	6.8%
U.S. Municipals	-0.5%	-1.3%	-0.8%	3.1%
Non-U.S. Developed	-0.5%	-4.1%	-1.9%	1.0%
EM $ Bonds	-0.1%	-4.8%	-4.4%	6.8%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-6.2%	8.9%	20.1%	$72.83
Gold	-0.1%	-5.4%	-3.4%	$1,233
Copper	2.0%	-13.3%	-9.3%	$6,283

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.1%	-5.1%	-2.3%	1.14
USD/Yen	1.2%	0.5%	-0.8%	113.20
Pound/USD	1.1%	-4.0%	-0.7%	1.30

Source: Bloomberg. As of Nov. 2, 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. 5 ISM U.S. non-manufacturing Purchasing Managers' Index (PMI); Bank of Japan monetary policy meeting minutes

Nov. 6 U.S. midterm elections; Germany factory orders

Nov. 8 Federal Open Market Committee (FOMC) meeting; China trade balance; Germany trade balance

Nov. 9 U.S. Producer Price Index (PPI); University of Michigan Surveys of Consumers

The Fed's policymakers are expected to keep rates unchanged at this week's FOMC meeting. But markets will be looking for clues as to the central bank's future policy direction. Comments on the strength of the economy would be seen as a hint that the Fed is likely to raise rates next month as expected, and any signs of anxiety around the recent market volatility and trade conflicts could be viewed as dovish.

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	*	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.BII1118U/E-650009-2016022

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