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BLACKROCK INVESTMENT INSTITUTE

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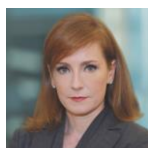

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WEEKLY COMMENTARY • DEC. 17, 2018

Key points

1. We draw three lessons from 2018, a year in which navigating markets has been tough amid trade frictions, rising rates and some sharp turns.
2. Equities fell, as weaker-than-expected economic data sparked growth slowdown fears. The UK's Theresa May won a party confidence vote.
3. The Federal Reserve is expected to raise rates this week, and any signs about its future tightening path – and a possible pause – will be in focus.

1 Three investing lessons from 2018

Navigating markets in 2018 has been tough. Returns in many bond, equity and credit markets globally verge on finishing the year in negative territory. We find uncertainty around trade, together with higher interest rates, has been a major drag on stocks, offsetting solid earnings growth. The lesson, one of three from 2018: Geopolitics matter.

Chart of the week

Global equity valuations and market attention to geopolitical risks, 2016-2018

Source: BlackRock Investment Institute, with data from Thomson Reuters, December 2018. Notes: The Global BGRI line reflects our Global BlackRock Geopolitical Risk Indicator (BGRI). To calculate our Global BGRI, we identify specific words related to geopolitical risk in general and to our top 10 risks. We then use text analysis to calculate the frequency of their appearance in the Thomson Reuters Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average. The valuations line is based on the 12-month forward price-to-earnings (P/E) ratio for the MSCI All-Country World Index. It is not possible to invest directly in an index.

We had warned markets were vulnerable to temporary drawdowns in 2018 if tough U.S. trade talk turned into actions. Yet the magnitude of the impact of geopolitics on markets has surprised us. This effect on stocks is reflected in the decline in valuations in the chart above. It corresponds with a rise in market attention to the risk of global trade tensions throughout 2018 and with market concern about geopolitical risk overall remaining at a historically elevated level. This is reflected in our BlackRock Geopolitical Risk Indicators. Geopolitical risks beyond the U.S.-China trade relationship have also played a role this year in European markets and in many emerging markets (EM), where the risks have been more local.

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Adapting to rising rates and building portfolio resilience

We find trade frictions are more baked into asset prices than a year ago. Yet we expect the vagaries of U.S. trade policy changes to cast a shadow over markets. Another geopolitical risk causing us worry: the risk of fragmentation in Europe. Overall, we expect further market sensitivity to geopolitical risks in 2019 as global growth slows: We find the impact of geopolitical shocks on global markets tends to be more acute and long-lasting when the economy is weakening. See our BlackRock geopolitical risk dashboard.

Our second lesson from 2018: Rising short-term yields have made cash a viable alternative to riskier assets for U.S.-dollar-funded investors and have exposed markets with weak fundamentals. Two-year U.S. Treasury yields are now more than three times their average over the post-crisis period. Rising rates hit EM assets much harder than we expected this year and led to a wide dispersion in EM returns. We see many EM assets offering better compensation for risk as we head into 2019, with the Fed likely pausing its quarterly pace of hikes amid slowing growth and contained inflation. But EM countries with large external liabilities are vulnerable to any greater-than-expected Fed tightening.

The final lesson: Build portfolio resilience. Broad market drawdowns have become more frequent in 2018 as volatility has risen from the doldrums of 2017. Many market segments have fallen sharply, from financial stocks and crypto currencies to perceived safe-havens such as telecom stocks. We would be wary of assets seeing sharp price rises that are disconnected from fundamentals. We prefer a barbell approach: exposures to government debt as a portfolio buffer on one side and allocations to assets offering attractive risk/return prospects such as quality and EM stocks on the other. This includes steering away from assets with limited upside if things go right, but hefty downside if things go wrong. We see European equities and European sovereign bonds falling into this category. Read more in our 2019 Global investment outlook. The Weekly commentary will resume on Jan. 7. Happy holidays.

2 Week in review

- Global equity markets fell, as disappointing economic data from Japan, China and Europe sparked global growth slowdown fears, and concerns around trade frictions and European politics added to the macro uncertainty. China's November retail sales and industrial production came in lower than expected, as did eurozone December flash PMIs. U.S. retail sales beat expectations.
- Britain's Prime Minister Theresa May won a leadership challenge within the UK's Conservative party, ensuring she won't face a similar no-confidence vote for another year. Yet May then failed to win concessions from the EU that could have made the UK Parliament more likely to pass her Brexit withdrawal-agreement proposal. The British pound was volatile.
- Italian government bond yields declined on a more meaningful-than-expected reduction of the planned Italian budget deficit, though it may not be enough to avoid an "excessive deficit procedure" from the European Council. The European Central Bank confirmed it will end its net asset purchases in December, and clarified that it will continue with reinvestments until at least after its first rate hike.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-1.2%	-0.9%	0.0%	2.1%
U.S. Small Caps	-2.5%	-7.0%	-5.2%	1.4%
Non-U.S. World	-1.0%	-12.8%	-10.8%	3.5%
Non-U.S. Developed	-0.9%	-12.2%	-10.7%	3.7%
Japan	-2.2%	-10.4%	-10.0%	2.5%
Emerging	-1.0%	-14.2%	-11.2%	3.1%
Asia ex-Japan	-0.5%	-13.8%	-11.6%	2.9%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.0%	-0.3%	-0.5%	2.9%
U.S. TIPS	-0.7%	-1.8%	-1.5%	3.0%
U.S. Investment Grade	0.3%	-2.9%	-2.8%	4.3%
U.S. High Yield	0.1%	0.0%	0.2%	7.3%
U.S. Municipals	-0.2%	0.6%	0.6%	2.8%
Non-U.S. Developed	-0.6%	-4.0%	-3.2%	1.0%
EM $ Bonds	0.6%	-4.2%	-3.9%	6.8%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-2.3%	-9.9%	-4.8%	$60.28
Gold	-0.8%	-4.9%	-1.1%	$1,239
Copper	-0.2%	-15.4%	-9.7%	$6,132

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.6%	-5.8%	-4.0%	1.13
USD/Yen	0.6%	0.6%	0.9%	113.39
Pound/USD	-1.1%	-6.9%	-6.3%	1.26

Source: Bloomberg. As of Dec. 14, 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

Dec. 18	U.S. housing starts, building permits	**Dec. 20**	Bank of Japan statement; Bank of England summary
Dec. 19	Fed's Federal Open Market Committee (FOMC) statement, U.S. current account, existing home sales; Japan balance of trade	**Dec. 21**	Japan consumer price inflation; U.S. PCE; eurozone consumer confidence flash; China's Central Economic Work Conference (expected Dec. 19-21, President Xi Jinping speech expected)

Markets currently price in a roughly 75% probability that the FOMC will raise interest rates by a quarter percentage point this week. Any signs about the Fed's path ahead will be in focus, with the Fed's "dot plot" suggesting the median policy maker expects three hikes. We view two rate increases next year as more likely, while markets are currently pricing in only one. We see the FOMC pausing its quarterly pace of hikes in 2019 amid slowing growth and inflation. U.S. rates are en route to neutral – the level at which monetary policy neither stimulates nor restricts growth – and we see the Fed becoming more cautious as neutral nears.

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 have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our 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 and 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 much has been priced in. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. 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	—	Higher yields and a flatter curve after a series of Fed rate increases make short-to-medium term bonds a more attractive source of income. Longer maturities are also gaining appeal as an offset to equity risk, particularly as the Fed gets closer to neutral and upward rate pressure is more limited. We see reasonable value in mortgages. Inflation-linked debt has cheapened, but we see no obvious catalyst for outperformance.
	U.S. municipals	—	Solid demand for munis as a tax shelter and expectations for muted issuance should support the asset class. We prefer a long duration stance, expressed via a barbell strategy focused on two- and 20-year maturities.
	U.S. credit	—	Solid fundamentals support credit markets, but late-cycle economic concerns pose a risk to valuations. We favor an up-in-quality stance with a preference for investment grade credit. We hold a balanced view between high yield bonds and loans.
	European sovereigns	▼	Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials have made European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect quite a bit of risk.
	European credit	—	Valuations are attractive, particularly on a hedged basis for U.S. dollar investors. We see opportunities in industrials but are cautious on other cyclical sectors. We favor senior financial debt that would stand to benefit from any new ECB support, over subordinated financials. We prefer European over UK credit on Brexit risks. 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. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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