BLACKROCK INVESTMENT INSTITUTE

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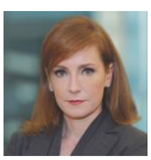

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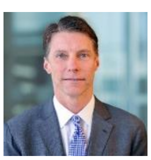

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WEEKLY COMMENTARY • APRIL 22, 2019

Key points

1. As a global benchmark bond index begins including Chinese bonds, we favor maintaining exposure and preparing to invest more.
2. Data last week confirmed a pickup in Chinese economic activity. Health care stocks tumbled on fears of drug pricing and Medicare reforms.
3. The earnings season gets into full gear this week, with average U.S. earnings expected to contract for the first time in nearly three years.

1 Emerging opportunities in China bonds

China's local-currency bond market is opening up to global investors. The Bloomberg Barclays Global Aggregate Index begins including yuan-denominated bonds this month, automatically adding exposure to such bonds for index investors. We favor maintaining such passive exposure and preparing to invest more.

Chart of the week

China and developed market bond yields, 2005-2019

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, April 2019. Notes: Chinese bonds are represented by the J.P. Morgan GBI-Emerging Markets Broad Diversified China Index, and developed market bonds by the Bloomberg Barclays Global Aggregate Index.

The inclusion of local-currency government and policy bank securities into the global bond market benchmark index is set to gradually occur over a 20-month period. Those passively invested in that index will, by default, add Chinese bond exposure to their holdings – which we view as a positive. Local-currency Chinese bonds are set to make up roughly 6% of the global fixed income benchmark when the phase-in is complete. At that stage, China's yuan currency will be the fourth-largest component in the index, behind the U.S. dollar, euro and Japanese yen. The chart above shows one reason we advocate investors maintain the inclusion exposure: Local-currency Chinese bond yields this decade have been materially higher than the average yields of the developed market bonds that make up the majority of the global bond index. See the top line in the chart above.

A very good place to start

We see China becoming a growth turnaround story this year, as policy makers ease fiscal and monetary policies and market fears of a U.S.-China trade war dissipate (see our Q2 Global investment outlook). Improvements in the domestic economy should result in rising yields and a stable or appreciating yuan currency. Christian Carrillo of BlackRock's Asia Pacific fixed income team sees the higher yields of Chinese bonds creating a tactical opportunity to add additional exposure in the future. His team estimates the fair value yield of 10-year Chinese government bonds will rise slightly in the second half amid positive economic data surprises and stabilizing inflation, but actual yields may rise more. Chinese bond prices may decline a bit as yields rise, but investors maintaining exposure stand to benefit from both relatively high income and potential currency gains. China's bond market has been dominated by domestic investors, and offers diversification benefits as a result. The correlation between Chinese bond and U.S. Treasury prices has been close to zero over the past five years. This benefit may diminish over time as foreign investors' ownership share of the market increases.

What are the other risks and challenges? We believe investors who hedge their currency exposure should take a patient approach toward Chinese bonds, as hedging costs currently are significant. This could improve over time as affordable hedging instruments become available. Liquidity is also a concern, particularly for investors with shorter-term horizons. The domestic Chinese investor traditionally has had a "buy and hold" approach to investing. As more foreign investors gain access to this market and trading begins between onshore and offshore players, liquidity should improve.

Bottom line: China's bond market is the world's third-largest, with about $13 trillion in outstanding bonds. We believe the market's size, attractive yields and diversification benefits mean it cannot be ignored, similar to our view on China's domestic equity market. We see China's inclusion in global bond benchmarks as a key event. Understanding the market is key. We believe maintaining automatic exposures and preparing to invest more is a very good place to start.

2 Week in review

- Chinese economic data confirmed the pickup in economic activity evident in recent better-than-expected March China Purchasing Managers' Index (PMI) data, offering more signs that China's stimulus package is starting to feed through into the data. Industrial production and retail sales figures beat expectations, while first-quarter gross domestic product (GDP) growth came in at 6.4% year-over year, marginally above analysts' estimates.
- U.S. retail sales beat expectations in March, posting their biggest monthly increase since September 2017. U.S. factory expansion softened. Germany's manufacturing activity shrank for a fourth straight month but its services activity rose to a seven-month high.
- Global stocks rose. Health care stocks underperformed amid investor concerns about potential drug pricing reform and Medicare-for all-proposals in the U.S. Financial stocks benefited from a mini-rotation as a result, even as U.S. financials kicked off earnings season with mixed results. Some financials guided lower on net interest margin, while still maintaining their outlook for loan growth.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.6%	16.6%	9.4%	2.0%
U.S. Small Caps	-0.8%	16.6%	0.2%	1.6%
Non-U.S. World	0.7%	13.7%	-3.4%	3.1%
Non-U.S. Developed	0.7%	13.1%	-3.7%	3.3%
Japan	0.4%	7.6%	-7.8%	2.4%
Emerging	0.5%	13.6%	-4.5%	2.6%
Asia ex-Japan	0.5%	14.8%	-2.7%	2.4%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.2%	1.4%	4.1%	2.6%
U.S. TIPS	-0.1%	2.9%	2.3%	2.7%
U.S. Investment Grade	0.0%	5.2%	5.3%	3.7%
U.S. High Yield	0.2%	8.4%	5.6%	6.2%
U.S. Municipals	0.0%	2.7%	5.0%	2.4%
Non-U.S. Developed	-0.5%	0.9%	-5.0%	0.8%
EM $ Bonds	0.1%	7.1%	4.4%	6.0%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.6%	33.8%	-2.1%	$ 71.97
Gold	-1.3%	-0.6%	-5.5%	$ 1,275
Copper	1.1%	8.6%	-7.8%	$ 6,476

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.2%	-2.1%	-9.2%	1.12
USD/Yen	0.3%	2.2%	4.4%	111.98
Pound/USD	-0.4%	1.9%	-8.5%	1.30

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of April 18, 2019. Notes: Weekly data through Thursday. 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.

3 Week ahead

April 23	U.S. new home sales; Eurozone consumer confidence
April 25	Bank of Japan interest rate decision; U.S. durable goods orders
April 26	Japan Consumer Price Index, unemployment rate, industrial production, retail sales; U.S. GDP
April 28	Spain general election

First-quarter earnings get into full swing this week. Analysts expect average U.S. earnings will contract year-over-year for the first time in 10 quarters, with weakness across sectors. The anticipated softness comes amid tougher year-over-year comparisons. Key things to watch include: the scope of the earnings deterioration; any slippage in record-level profit margins; and corporate discussion of wage pressures and other input costs. Analysts expect the first quarter to be the weakest of the year, with earnings and sales recovering over the rest of the year. They see full-year 2019 global earnings per share expanding by 4.8% and global sales by 4.1%.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. 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	—	We are cautious on U.S. Treasury valuations after the recent rally, but still see them as portfolio diversifiers given their negative correlation with equities. We expect a gradual steepening of the yield curve, driven by still-solid U.S. growth, a Fed willing to tolerate inflation overshoots — and a potential shift in the Fed's balance sheet toward shorter-term maturities. This supports two- to five-year maturities and inflation-protected securities.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	A still-growing economy, reduced macro volatility and a decline in issuance support credit markets. Conservative corporate behavior – including lower mergers and acquisitions volume and a focus on balance sheet strength – also help. We favor BBBs and prefer bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of easy ECB policy or pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. Yet any further deterioration in U.S.-European trade tensions could push yields lower.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich after a dramatic rally. We prefer high yield credits, supported by muted issuance and strong inflows.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "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.

BlackRock Investment Institute

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