BLACKROCK INVESTMENT INSTITUTE

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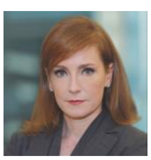

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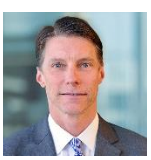

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Key points

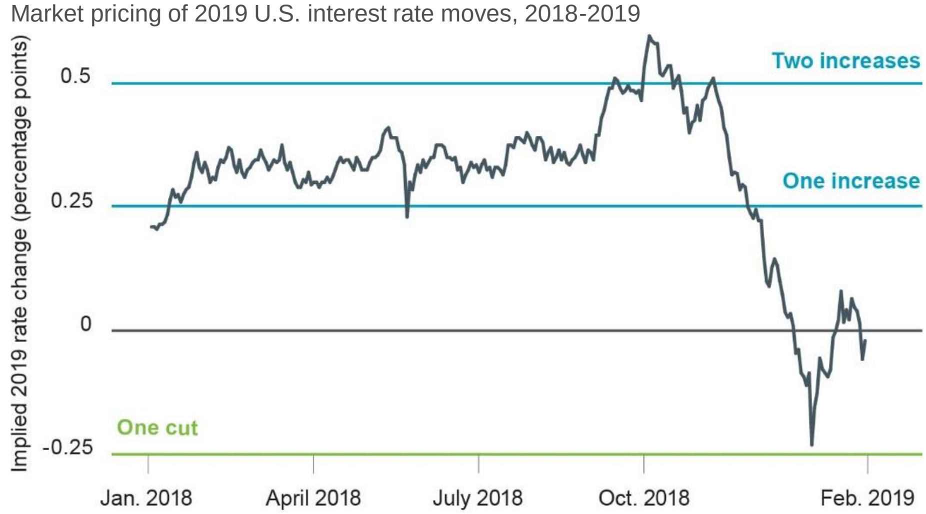
1. We argue for a carefully balanced investment approach as global risk assets have bounced back from the late 2018 selloff.
2. The Federal Reserve's dovish messaging helped lift stocks. U.S. government bond yields hit nearly one-month lows before reversing.
3. Markets will look at the extent of any rebound in this week's German manufacturing data to help gauge the health of the eurozone economy.

1 To chase or not to chase the rally?

Global markets have started 2019 on firmer footing after losses in 2018. We see equities and bonds eking out positive returns this year, and still advocate a carefully balanced approach in portfolios due to late-cycle concerns and ongoing geopolitical uncertainties. We caution against chasing the rally in risk assets, particularly in areas vulnerable to growth downgrades, geopolitical risks or sudden shifts in supply/demand dynamics.

Chart of the week

Market pricing of 2019 U.S. interest rate moves, 2018-2019



There is no guarantee that any forecasts made will come to pass. Source: BlackRock Investment Institute with data from Bloomberg, February 2019. Notes: The chart shows the market-implied change in short-term U.S. interest rates over 2019, as reflected by Eurodollar futures pricing. We use the price of the December 2019 contract to represent implied end-2019 rates. The implied changes are represented by the price differences between that contract and the contracts for December 2018 delivery (before its expiry on Dec. 12, 2018), for January 2019 delivery (before its expiry on Jan. 14, 2019) and for February 2019 delivery. We assume rate moves are 25 percentage points.

Global stocks kicked off 2019 with a bang – posting their best month in more than eight years. Other risk assets also rallied. A key impetus: a big shift in policy expectations across the globe. Markets have moved from pricing in two 2019 rate increases by the Fed in November, to flirting with the potential of a cut. See the chart above. The Fed has pledged patience and flexibility in future rate moves and signaled the potential of maintaining a larger-than-expected balance sheet. Fed policymakers are not alone in sounding more dovish. China has signaled a move to easier credit and fiscal conditions. We are also seeing increasingly expansionary fiscal policy in Europe: Italy and Spain are already ramping up public spending in 2019, France has pledged to cut taxes and increase wages, and Germany is considering tax cuts.

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Consider the risks

Also helping to soothe market jitters: moderating market concerns around geopolitics. Market attention to geopolitical risks has dipped from the elevated levels seen in the second half of 2018, our BlackRock geopolitical risk dashboard shows. Markets now see a higher likelihood of a limited U.S.-China trade deal. This eases a major source of market angst, though any disappointment could sting more. Some pockets of the markets, such as high yield and emerging market debt, have been supported by lower-than-usual issuance. Yet such supply/demand dynamics could change quickly.

Can the risk rally be sustained? The U.S. economy has entered late cycle. This phase historically has been associated with positive stock and bond returns – and frequently has rewarded risk taking. Two examples are the late 1990s and 2006, when global equities and bonds both posted double-digit returns. Yet we see reasons for caution. Late cycles have come with higher volatility in the last three decades, our analysis finds. Near-term consensus expectations for economic and earnings growth still appear high, even though we view the risk of a 2019 U.S. recession as low. We also see geopolitical risks as a persistent force in markets – with the strategic confrontation between the U.S. and China over technology dominance and threats to European political stability as two underappreciated risks over the medium term. Another factor to consider: Financial asset valuations are now less compelling than in late 2018.

Our base case: A modest easing of financial conditions globally is likely sufficient to stabilize growth in the second half of 2019. Any decisive move in global monetary and fiscal positions toward a more growth-friendly stance could trigger a renewed bull market, we believe. Yet we still argue for a carefully balanced investment approach. This includes taking risks where they are being sufficiently rewarded. Cash is less attractive than equities and bonds. Bonds offer slightly higher returns and significantly greater diversification benefits than they did in 2018. We prefer equity over credit, and emerging markets over developed markets outside of the U.S.

2 Week in review

- The Fed's dovish tone helped boost risk assets. U.S. government bond yields dropped to the lowest since early January before bouncing back. The U.S. earnings season produced mostly modest surprises, and those were met with strong price reactions. Bloomberg confirmed it would start adding Chinese yuan-denominated government and policy bank bonds to the Bloomberg Barclays Global Aggregate Index in April.
- Robust jobs data pointed to ongoing strength in the U.S. labor market. January's nonfarm payrolls notched the largest increase since February 2018. China's manufacturing activity shrank in January for the second consecutive month, underlining worries about a further slowdown in the world's second-largest economy.
- High-level U.S.-China trade talks ended with China's pledge to buy more U.S. soybeans. U.S. President Donald Trump and Chinese President Xi Jinping are expected to meet soon, yet we see long-term structural rivalry between the two nations persisting.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	1.6%	8.1%	-2.2%	2.1%
U.S. Small Caps	1.3%	11.5%	-3.7%	1.7%
Non-U.S. World	1.2%	7.5%	-12.5%	3.3%
Non-U.S. Developed	0.9%	6.5%	-12.6%	3.5%
Japan	0.2%	5.4%	-13.6%	2.5%
Emerging	1.7%	8.8%	-13.8%	2.8%
Asia ex-Japan	1.5%	7.4%	-13.8%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.4%	0.2%	2.7%	2.7%
U.S. TIPS	1.0%	1.1%	1.1%	2.8%
U.S. Investment Grade	0.9%	2.2%	0.9%	3.9%
U.S. High Yield	0.8%	4.7%	2.0%	6.9%
U.S. Municipals	0.4%	0.7%	3.3%	2.6%
Non-U.S. Developed	0.7%	1.6%	-3.4%	0.9%
EM $ Bonds	0.8%	4.5%	0.2%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.8%	16.6%	-9.9%	$ 62.75
Gold	1.1%	2.7%	-2.3%	$ 1,318
Copper	1.4%	2.9%	-13.8%	$ 6,139

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.4%	-0.1%	-8.4%	1.15
USD/Yen	0.0%	-0.1%	0.1%	109.50
Pound/USD	-0.9%	2.6%	-8.3%	1.31

Source: Thomson Reuters. As of Feb. 1, 2019. 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

Feb. 4 U.S. factory orders

Feb. 5 President Trump gives the annual State of the Union address; eurozone retail sales

Feb. 6 U.S. productivity and labor costs; German manufacturing orders

Feb. 7 German industrial output

Data out of the eurozone this week, including Germany's factory orders and output, could offer a gauge of the health of the region's economy. Markets will look for some rebound in the data following sharp declines in prior months, yet year-end seasonality may inject noise. One-off factors may have contributed to some of the weakness in Germany's manufacturing sector, but our BlackRock GPS still sees a very subdued pace of growth in Germany and the eurozone this year.

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 ongoing economic expansion 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	▼	Weak economic momentum and political risks are challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see solid corporate fundamentals and cheap valuations as supportive, but the market lacks a clear catalyst for sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, coupled with a backdrop of economic reforms and policy stimulus, 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	—	An expected pause in the Federal Reserve's policy normalization, and softening economic data in the near term, should support flows into Treasuries. We are modestly positive on longer maturities, but see 10-year yields range-bound. A more negative equity/bond correlation makes Treasuries an attractive portfolio diversifier.
	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, but the upcoming European elections cycle is an important source of risk.
	European credit	—	We see compelling relative value in BBB-rated European credit, as it has lagged the recent rebound in other risk assets. A slowing, but growing global economy and major central banks on hold provide a positive backdrop for credit. Yet we remain neutral overall, given still-anemic eurozone growth and ongoing political risks.
	EM debt	—	Valuations remain attractive despite the recent rally, and limited issuance in recent months is supportive. A pause in U.S. monetary policy tightening and U.S. dollar strength removes a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
	Asia fixed income	—	We focus on quality credit, including investment grade in India, China and parts of the Middle East. We also favor high yield in Indonesia and in China's real estate sector. We have low conviction on local currency debt markets and see the Chinese yuan benefiting from any easing in U.S.-China trade conflicts.
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.BIIM0219U-734001-3/4

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