



Global Investment Outlook

Q4 2018

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Richard Turnill
Global Chief
Investment Strategist
BlackRock Investment
Institute

We revisit our 2018 investment themes and take a deep dive into the prospects for emerging market (EM) assets after an unexpectedly drawn-out selloff.

- **Themes:** We see the steady global expansion rolling on, underpinned by above-trend U.S. growth. Yet the range of potential economic outcomes is widening. Stimulus-fueled surprises and productivity gains could boost growth and risk assets, whereas escalating trade disputes and rising price pressures could create downside risks. Gradual increases in U.S. rates are tightening financial conditions globally, and have contributed to bouts of volatility and sharply depreciating EM currencies. This argues for a greater focus on making portfolios more resilient to downside shocks.
- **EM under pressure:** The EM world has been hit by a series of country-specific shocks – and tightening financial conditions pressuring those with the greatest external vulnerabilities. This was not how we envisioned the EM story playing out this year. We see room for a recovery, especially in equities. China's economy looks resilient, EM fundamentals are generally robust, and we may be near a peak in idiosyncratic risks. Valuations reflect much potential downside. The Federal Reserve is set to keep raising rates gradually and could start to slow its balance sheet wind-down next year. Risks include escalating trade frictions, hefty portfolio outflows, and a hawkish Fed pushing up global rates and the U.S. dollar.
- **Market views:** We favor equities over bonds but see an uneasy equilibrium between rising macro uncertainty and strong corporate earnings growth. This calls for portfolio resilience, expressed through our preference for quality exposures and U.S. equities over other regions. In fixed income, we favor short-term bonds in the U.S. and an up-in-quality stance in credit. Rising risk premia have created value in EM equities, including in the hard-hit tech sector. We prefer selected hard-currency EM debt over the local variety on relative valuations and the insulation they provide against currency depreciations.



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Elga Bartsch
Head of Economic and
Markets Research
BlackRock Investment
Institute



Isabelle Mateos y Lago
Chief Multi-Asset Strategist
BlackRock Investment
Institute



Kate Moore
Chief Equity Strategist
BlackRock Investment
Institute



Jeff Rosenberg
Chief Fixed Income Strategist
BlackRock Investment
Institute

Macro outlook and themes

A solid near-term global growth outlook is clouded by persistent and elevated uncertainties. Above-trend U.S. economic activity is underpinning G7 gross domestic product (GDP) growth. Consensus views for G7 growth have pulled back relative to our *BlackRock Growth GPS*, creating the potential for upside surprises. U.S. fiscal spending is picking up into year-end, keeping the risk of economic overheating on our radar. This comes as the Federal Reserve presses on with its normalization campaign, bringing interest rates closer to “neutral” levels that may stoke worries policy will actually become tight. Trade tensions show few signs of abating. Tariffs have the potential to disrupt supply chains, increase price pressures and dent confidence. Economists have become divided on the two-year outlook compared with last year: More are penciling in downside forecasts. See the *Heightened uncertainty* chart.

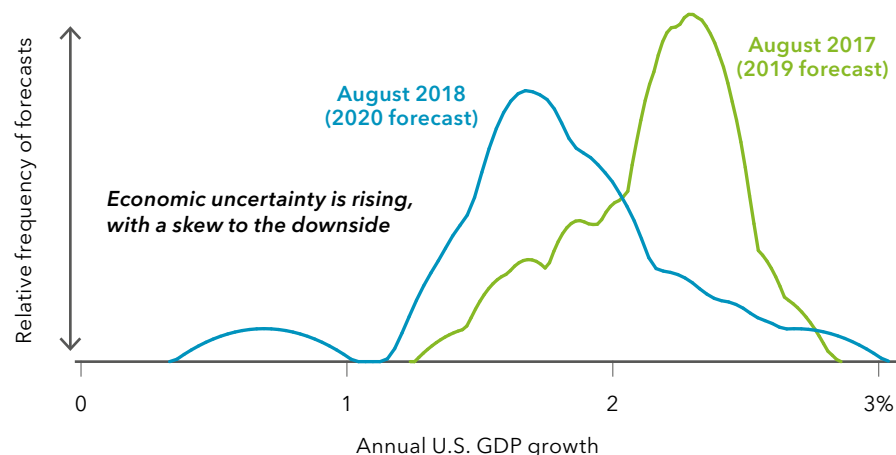
We believe global growth can sustain at above-trend levels, even as the range of potential macro outcomes widens heading into 2019.

The three themes from our *Midyear investment outlook* still ring true: a widening range of growth outcomes, tighter financial conditions and a rising need for portfolio resilience. Tighter financial conditions partly played out through a stronger U.S. dollar. This exacerbated the troubles of the most vulnerable EM economies. Trade frictions and the dollar’s path remain key for EMs. Higher U.S. interest rates are also adding to EM stress by creating competition for capital. Investors can now receive decent returns in U.S. short-term bonds without having to take major credit and duration risk. Investors have reset their return expectations for riskier assets as a result, especially EM assets and equities. See the *Great repricing* chart. This repricing has sparked market volatility, reinforcing our view that it is important to build greater resilience into portfolios through quality exposures across equities and credit.

We believe equity investors are broadly compensated for growing risks, but advocate a greater focus on fortifying portfolios amid macro uncertainty.

Heightened uncertainty

Distribution of two-year forward U.S. GDP forecasts, 2018 vs. 2017

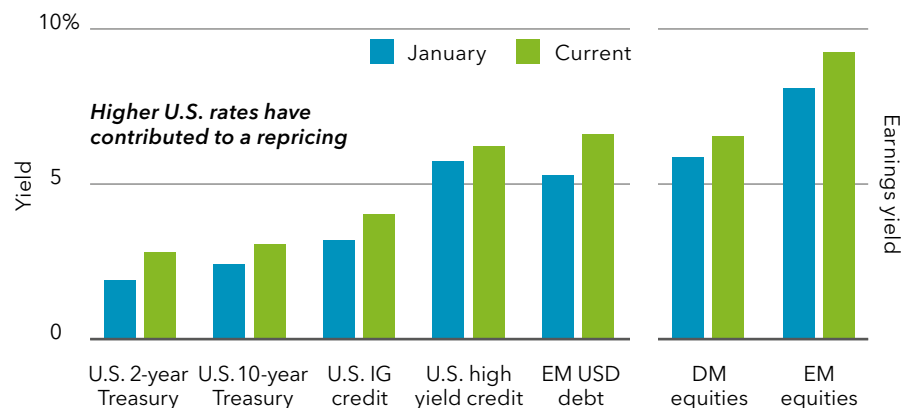


Sources: BlackRock Investment Institute, with data from Consensus Economics, September 2018.

Notes: The lines show the distribution of two-year forward U.S. GDP growth forecasts as of August 2018 and August 2017. The vertical axis shows the relative frequency of each forecast. Forward-looking estimates may not come to pass.

Great repricing

Asset yield comparison, January vs. September 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, September 2018. Notes: Indexes used from left to right are: Thomson Reuters Datastream 2-year and 10-year U.S. Government Benchmark Indexes, Bloomberg Barclays U.S. Credit Index, Bloomberg Barclays U.S. High Yield Index, JP Morgan EMBI Global Diversified Index, MSCI World Index and MSCI Emerging Markets Index. Yield in the two equity markets is represented by 12-month forward earnings yield.

EM downdraft

This year's EM troubles stem from a potent cocktail of negatives. Catalysts ranged from country-specific factors (Turkey's credit-fueled growth running out of steam; Argentina's policy missteps) to worsening trade tensions, a crowded EM election calendar and moderately tighter global financial conditions (higher U.S. rates and a stronger dollar). The biggest casualties: currencies of EM economies with the largest current account deficits and highest external debt burdens. Countries with surpluses, such as South Korea and Thailand, have largely been spared a currency crunch. See the *Weak links* chart. Is the EM selloff a canary in the coal mine for global markets? We see it more as a series of idiosyncratic accidents that have masked stronger EM fundamentals. With much of the steam let out of valuations, a robust growth backdrop, and potential for the Fed to slow its pace of policy normalization, we see room for a rebound.

Country-specific EM fragilities came home to roost this year – yet we don't see these as a threat to global markets.

EM currencies have borne the brunt of the recent selloff. Volatility in EM currencies has spiked to higher levels than the 2013 "taper tantrum" – when then Fed Chair Ben Bernanke signaled the beginning of the end of new asset purchases. Yet there has been no visible contagion to other global asset classes. See the *Crisis as usual* chart. Currencies have shown some signs of stabilization recently, with emergency rate hikes in Turkey and Argentina stemming the tide. This is a positive sign for EM assets overall, which appear to offer attractive compensation for their risks. We stick to our overweight stance on EM equities and see selected opportunities in EM debt. *See pages 7 and 8* for details.

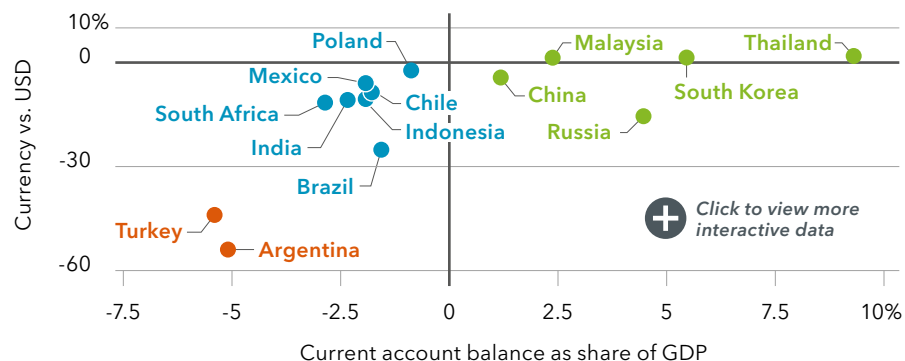


"The current EM equity drawdown isn't any worse than any other post-crisis selloff. The persistence is the difference – and it's unusual amid a strong economic outlook."

Gerardo Rodriguez – EM Portfolio Manager, BlackRock Systematic Active Equity

Weak links

EM current account balances vs. 12-month currency returns, September 2018

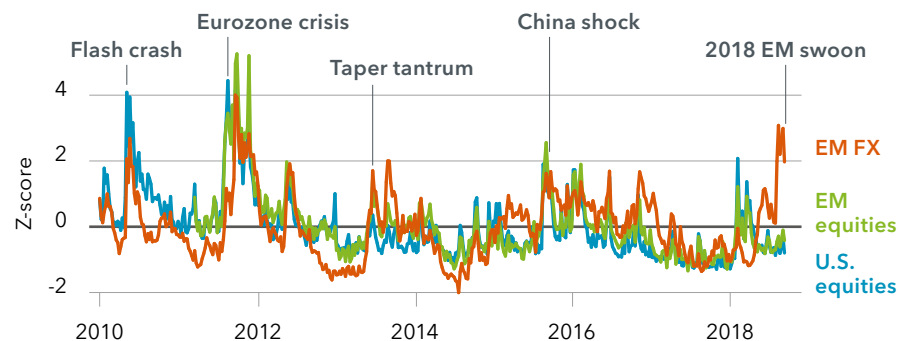


Sources: BlackRock Investment Institute, with data from the IMF and Thomson Reuters, September 2018.

Notes: The dots show the 12-month change in the spot currency exchange rate versus the U.S. dollar on the vertical axis, and the IMF estimate of the current account balance as a share of GDP for 2018 on the horizontal axis. According to the terms agreed upon in Argentina's Stand-By Arrangement (SBA) with the IMF, its current account deficit is projected to be -3.6% for 2018. We have used the pre-SBA figure in the chart above for a fairer comparison with peers.

Crisis as usual

Implied volatility of EM currencies, equities and U.S. equities, 2010–2018



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Sources: BlackRock Investment Institute, with data from Thomson Reuters, September 2018. Notes: The lines show the number of standard deviations from the average (z-score) since 2010. Volatility of EM FX (currencies) is based on a simple average of implied volatility for the Brazilian real, Turkish lira, South African rand, Polish zloty, Thai baht, Mexican peso, Indonesian rupiah and Indian rupee to dollar rates. Volatility of U.S. equities is based on the CBOE VIX Index, and EM equities on the CBOE Emerging Markets Volatility Index (data available from March 2011). "Flash crash" is the U.S. market crash of May 6, 2010; "eurozone crisis" marks the peak of Europe's sovereign debt crisis; "taper tantrum" is the 2013 market selloff on fears of the Fed winding down its asset purchase program; "China shock" is China's summer 2015 stock market crash.

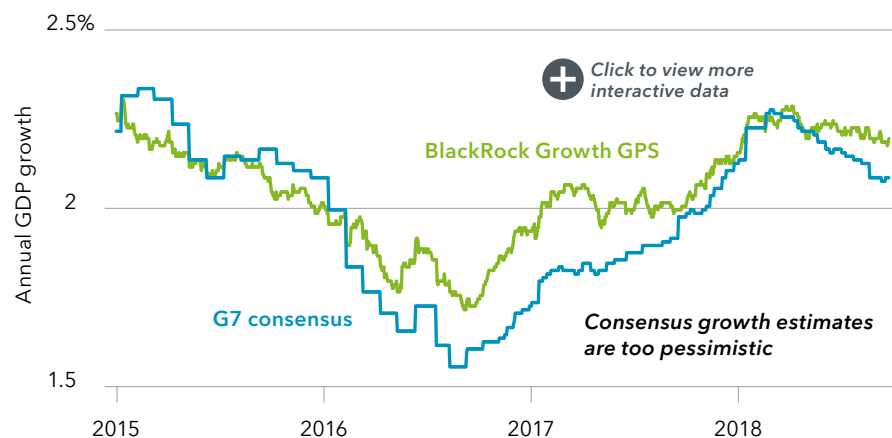
EM spillover debate

We don't expect the EM selloff to upend the global expansion. Most EM economies are holding up, and recessions in trouble spots like Turkey and Argentina should have limited impact. We see DMs as the key drivers of the global expansion – and EMs' fortunes. Our updated work on **global growth spillovers** suggests the impact of DM growth on EM is several times that of EM to DM – and China is the linchpin for transmitting growth. Our **BlackRock Growth GPS** points to steady economic activity in China – and potential for upgrades to G7 growth estimates. See the *DM in the driver's seat* chart.

Could things get worse for EM? The bear case: The Fed tightens more rapidly, the dollar strengthens, trade frictions worsen and portfolio outflows spur liquidity crises and EM tightening. We lean to the bull case: Many of these risks look to be priced in, especially in equities. Global financial conditions may not tighten much more, with the Fed moving closer to a "neutral" rate that neither helps nor hinders growth, and we could see an ebbing of individual EM crises.

DM in the driver's seat

BlackRock Growth GPS vs. G7 consensus, 2015–2018

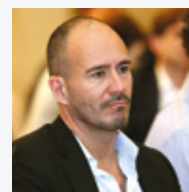


Sources: BlackRock Investment Institute, with data from Bloomberg and Consensus Economics, September 2018. Notes: The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. The G7 consensus is the 12-month consensus GDP forecast as measured by Consensus Economics. Forward-looking estimates may not come to pass.

Is the EM swoon the result of a series of unfortunate country-specific events, or is it a warning sign of trouble ahead for risk assets around the globe? We debated this in mid-September. Here are snippets:

"The global backdrop is still solid, global rates are low, and central banks haven't delivered any surprises this year. The big story of 2018 is increased macro risks. Trade tensions have escalated and that has put the spotlight on pre-existing vulnerabilities. Turkey is a Turkey story. EM troubles are not the canary in the coal mine for the end of this cycle, but they show that there will be consequences if trade tensions escalate."

Jean Boivin – Global Head of Research, BlackRock Investment Institute

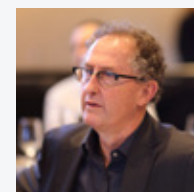


"Solid fundamentals and ample liquidity spurred a hunt for yield and a rush into EM debt. Now that financial conditions are tightening, some cracks are showing – especially for countries relying on market access to fund deficits. EM offers up good opportunities, though. When fundamentals are OK, most problems have been uncovered and assets have repriced."

Sergio Trigo Paz – Head of BlackRock's Emerging Markets Fixed Income

"EM was a crowded trade – and the usual suspects are now being hit. EM fundamentals only matter on the downshift; the U.S. dollar, interest rates and portfolio flows affect EM much more. The bear market is a symptom of late-cycle dynamics, not the cause. If there is contagion, it's buyer contagion. Fund redemptions can lead to forced selling, which leads to more price declines and selling."

Tom Parker – Chief Investment Officer, BlackRock Systematic Fixed Income



Flows and China

We have seen a trickle of outflows from EM funds, but no signs of investor capitulation yet. This is playing out in both EM debt and equities, but with important differences: The current swoon follows a period of heady inflows into EM debt strategies, as easy monetary policies depressed yields and pushed investors into riskier alternatives. By contrast, flows into EM equities since 2016 have been more muted. Cumulative net flows into the asset class since 2013 are negative, thanks to years of investor caution. See the *Turning tide?* chart.

What would it take to incite a genuine exodus from EM assets? Likely a recession in the developed world, we believe. We do not see this on a near-term horizon. Value seekers awaiting a capitulation in EM fund flows as a sign to jump back in may be waiting a long time, missing an opportunity in the process.

We see room for renewed flows into EM assets – particularly in equities, where investors are lightly positioned.

The EM selloff happened against an unusual backdrop of healthy global growth. China's campaign to improve the quality of credit has slowed growth, but our *BlackRock GPS* points to steady Chinese economic activity ahead that may once again defy skeptics. China is juggling competing objectives: reining in unregulated lending while trying to support the economy through bank credit, infrastructure project approvals and fiscal spending. This may provide support – with a lag – if China hits any air pockets along the way. Escalating trade frictions are the key risk to this outlook, and the market is focused on this risk. See the *Trade tremors* chart. This means much of the downside may already be priced in, we believe. See our *BlackRock geopolitical risk dashboard*.

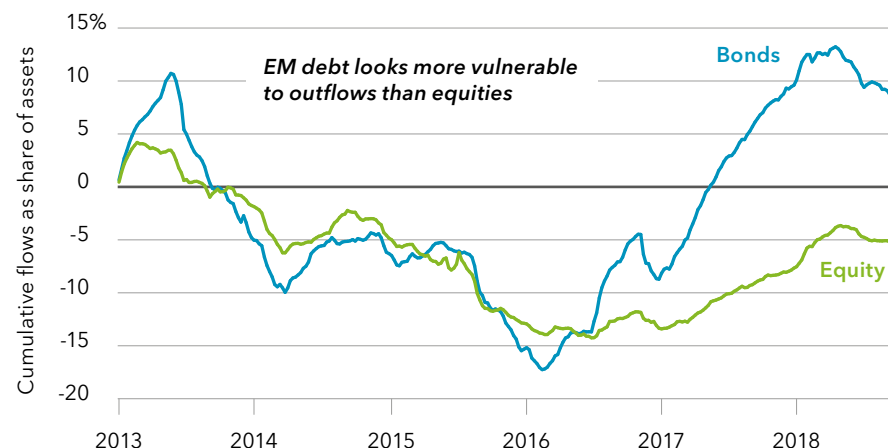


“China may accelerate structural reforms to offset rising trade risks. This could help restore some confidence in asset prices hit by market fears of a sharper-than-expected economic slowdown.”

Helen Zhu – Head of China Equities, BlackRock Fundamental Active Equity

Turning tide?

Cumulative flows to emerging market funds, 2013–2018



Sources: BlackRock Investment Institute, with data from EPFR, September 2018. Notes: The lines show cumulative net flows to EM-focused mutual funds and exchange-traded funds as a percentage of the assets under management in these funds at the start of 2013.

Trade tremors

BlackRock Geopolitical Risk Indicator for U.S.-China relations, 2005–2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters. Data as of Sept. 14, 2018. Notes: We identify specific words related to this geopolitical risk and 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 BGRI's risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

Fixed income

Hard-currency EM debt is gaining some appeal. Yields have risen to the top of their range this decade, erasing the usual gap with local currency yields. See the *Hard currency preferred* chart. Too soon to jump back in? No two downturns are identical, but historically this has been a good entry point. We analyzed EM hard-currency debt returns since 1994, using the benchmark JP Morgan EMBI Global Diversified Index. Each time trailing 12-month returns were of the current magnitude (a 4% loss), total returns were positive in the next 12 months.

Local-currency markets have been the main recipients of EMD inflows in recent years, putting them at risk of more outflows. And they are more exposed to any further weakness in EM currencies. Currency depreciation is a double-edged sword for EM. On the one hand, it acts as a stabilizing force in a crisis – helping rebalance current accounts. Yet it also comes as a market shocker.

We prefer selected hard-currency EMD, and are mostly steering clear of the local-currency variety.

The selloff in EMD has been an uneven one. Yield spreads on high yield EM sovereigns have soared, while their investment grade counterparts have largely weathered the storm. See the *Quality first* chart. Why? The drawdown to date has been concentrated in a handful of higher-yielding problem names. The result: few bargains in the high-grade EM issues that non-dedicated EM investors typically target. That said, we see value emerging for “crossover” investors who cast their nets across markets. The spread on the JP Morgan EMBI Global Diversified Index is trading above that of the Bloomberg Barclays Global High Yield Index for the first time since 2005.

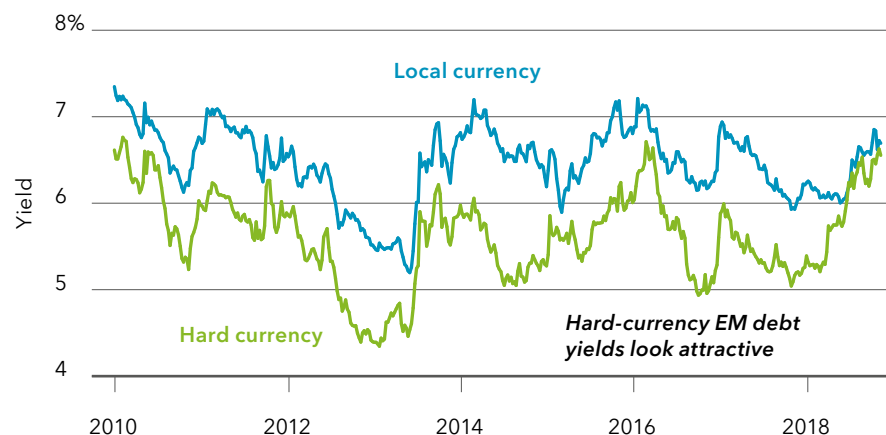


“The EM debt downturn has been about a series of unfortunate idiosyncratic events. There’s been huge dispersion: the weakness has been largely in vulnerable countries and bond issuers.”

Amer Bisat – Head of Sovereign and Emerging Markets Alpha, BlackRock Global Fixed Income

Hard currency preferred

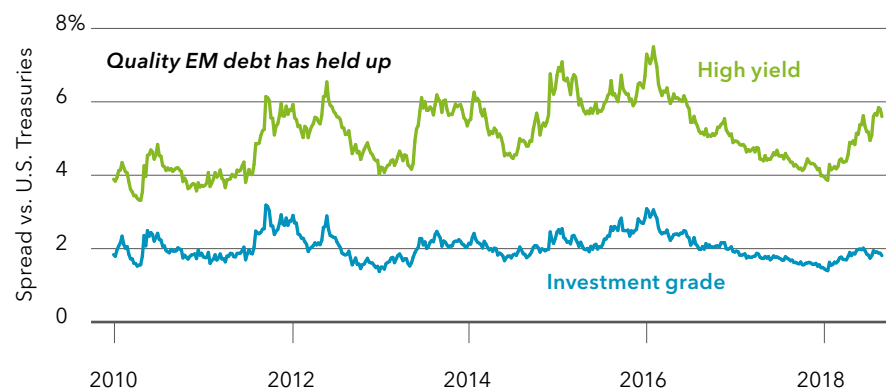
Emerging market hard- and local-currency debt yields, 2010–2018



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, September 2018. Notes: The lines show the yields on the JP Morgan EMBI Global Diversified Index (hard currency) and JP Morgan GBI-EM Global Diversified Index (local currency).

Quality first

EM debt yield spread vs. U.S. Treasuries, 2010–2018



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 Bloomberg and JP Morgan, September 2018. Notes: The green line shows the difference between the yields of EM high yield debt (represented by the JP Morgan EMBI Diversified High Yield Index) and U.S. Treasuries. The blue line shows the difference between the yields of EM investment grade debt (represented by the JP Morgan EMBI Diversified Investment Grade Index) and U.S. Treasuries. The yield spread is in percentage points.

Equities

It still pays to take risk in equities, we believe. Robust 2018 earnings estimates make the U.S. our favored region. We stick with our preference for momentum alongside quality exposures for added resilience. A duller earnings outlook and looming political risks have us less enthusiastic about Europe, while Japanese equities lack a clear catalyst to propel performance. We haven't lost confidence in EMs, where economic strength is starting to translate into sustained strong earnings growth for the first time in a decade. Consensus estimates as of September 2018 point to earnings-per-share (EPS) growth of 12% for 2019, with China at nearly 16%, Thomson Reuters data show. This compares with 10% EPS growth globally and has EMs just ahead of the U.S. The recent selloff also has restored a lot of value, and EMs are now trading at a large discount to DM equities. The *On sale* chart paints the picture. Value stocks may be particularly underappreciated in EM, our Risk and Quantitative Analysis team finds.

The 2018 selloff has restored value in EM, one of our favored regions.

What is feeding EM earnings? Changing sector composition is a big part of the story. We've seen a flood of new offerings in higher-profit new economy sectors that appears unlikely to abate. The technology sector, for example, has ballooned from 4% to 28% of the MSCI EM Index over the past 20 years. See the *Technology takeover* chart. Tech has led EM equities down this year amid tighter regulation in China and potential for trade risks to disrupt global supply chains. Yet valuations relative to DM tech are among the lowest seen in the past decade. This makes EM tech a large field that could be ripe for picking. We see potential opportunities in both consumer platforms and enterprise services.

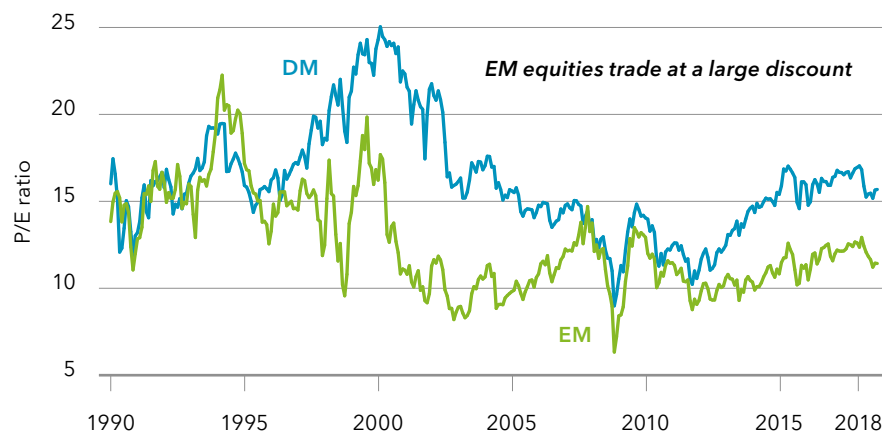


"I'm bullish on EM. The drawdown is of normal size and has been about isolated trouble spots; EM economies are in mid (not late) cycle; and valuations have become attractive."

Gordon Fraser – Portfolio Manager, BlackRock Global Emerging Markets Equities

On sale

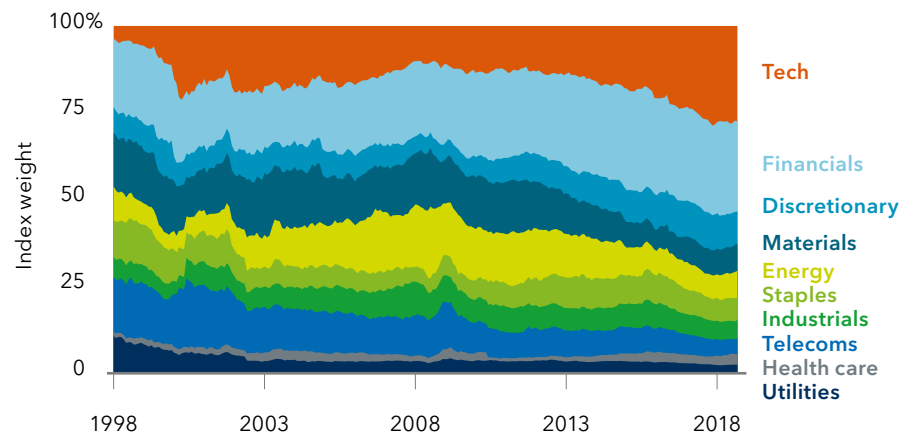
Emerging and developed market equity valuations, 1990–2018



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, September 2018. Note: The lines show the 12-month forward price-to-earnings ratios for the MSCI World Index (representing developed markets, or DM) and MSCI Emerging Markets Index (representing emerging markets, or EM).

Technology takeover

EM equity sector weightings, 1998–2018



Sources: BlackRock Investment Institute, with data from Thomson Reuters and MSCI, September 2018. Notes: The areas show the weight of each sector by market capitalization within the MSCI Emerging Markets Index. The financial and real estate sectors have been combined into "Financials." "Staples" refers to consumer staples, "Discretionary" refers to consumer discretionary, and "Tech" refers to information technology.

Assets in brief

Tactical views on assets, October 2018

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	— The market's value orientation is a challenge without a clear growth catalyst. Yen appreciation is another risk. Positives include shareholder-friendly corporate behavior, solid company earnings and support from Bank of Japan stock buying.
	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 prefer 15-year mortgages over their 30-year counterparts and versus short-term corporates.
	U.S. municipal bonds	— 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	▼ Increased issuance and political risks have widened spreads and created some value. Negative rates have crimped yields – but rate differentials make currency-hedged positions attractive for U.S.-dollar investors. We are cautious on subordinated financial debt despite cheaper valuations.
	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 healthy inventory balance underpins oil prices. Trade tensions add downside risk to industrial metals 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.

Note: Views are from a U.S. dollar perspective as of October 2018. *Given the breadth of this category, we do not offer a consolidated view.

▲ Overweight

— Neutral

▼ Underweight

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