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WEEKLY COMMENTARY • JUNE 3, 2019

Key points

1. Central bank policy will be in focus as the Fed considers new tools to better steer inflation expectations. We examine the implications.
2. Government bond yields slid to new lows last week on falling inflation expectations. Rising trade tensions sparked fresh growth concerns.
3. The European Central Bank meets this week, and markets will be looking for signs of whether the central bank's policy outlook is changing.

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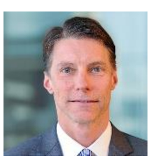

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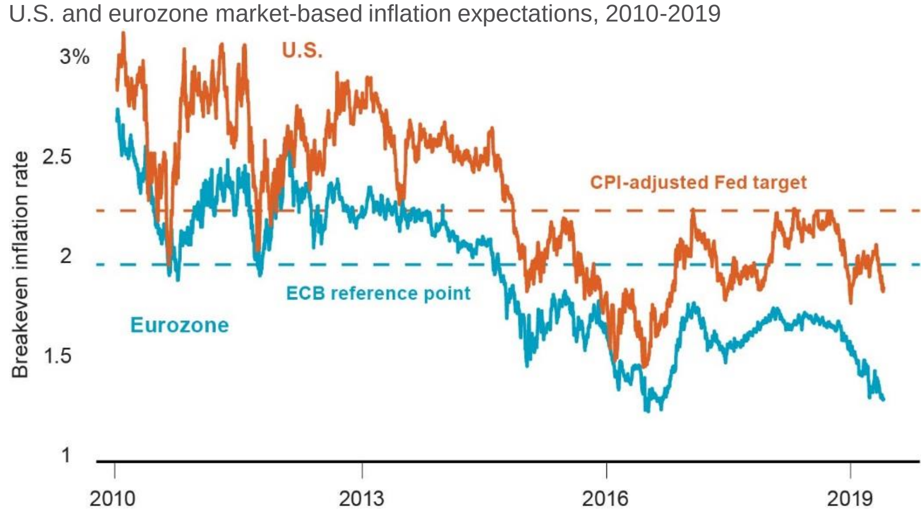
1 Getting a grip on inflation expectations

Inflation expectations have sharply fallen recently, driving down U.S. government bond yields and focusing attention on Fed policy. The market now expects three Fed rate cuts by the end of 2020. The Fed is getting concerned that its current toolkit won't effectively counter a future recession. Hence it's considering new strategies to boost inflation expectations, with important economic and market implications, in our view.

Chart of the week

U.S. and eurozone market-based inflation expectations, 2010-2019



Sources: BlackRock Investment Institute, with data from Bloomberg, May 2019. Notes: The chart shows the market pricing of inflation based on five-year forward inflation in five years' time, as measured in inflation swaps. The Fed target is adjusted 25 basis points higher to account for the difference in market pricing of the CPI index in inflation swaps relative to the PCE inflation index, the Fed's target. The ECB targets inflation just below a 2% reference point.

The Fed's review could lead to policy changes early next year. It will be in focus at a Federal Reserve Bank of Chicago conference this week. The review aims to address a two-fold challenge faced by central banks since the global financial crisis: falling neutral interest rates – rates that would neither stimulate nor curtail economic growth – and falling inflation expectations. Both could diminish monetary policy's ability to counter future downturns by reducing the distance between the actual interest rate and the lowest level of interest rates a central bank can feasibly set. The chart shows how inflation expectations have slipped meaningfully below targets after an extended period of actual inflation falling short of central bank targets. Expectations have not been as tethered to the targets as markets participants and central banks had hoped. The persistence of this trend could start to call into question the credibility of central banks' inflation targets, in our view.

Shifting to make-up strategies

The monetary policy options the Fed and other developed market central banks are discussing include a shift from flexible inflation targeting – maintaining the inflation rate near the target – to "make-up" strategies that would deliberately allow the economy to run hot for a while to compensate for a previous inflation shortfall. We assess the implications of such a shift in our new Macro and market perspectives *Fed to raise its inflation game?* co-authored with Bob Miller, BlackRock's Head of Fundamental Fixed Income - Americas, and Jonathan Pingle, Head of Economics for Global Fixed Income. Make-up strategies – average inflation targeting is one example – require markets believe that central banks will be able to push inflation above their targets despite central banks' current struggles to do this. Without this belief, it's unlikely central banks could engineer the required sizable swings in inflation expectations.

The economic impact would depend on the specifics of any Fed strategy shift. But a few common themes emerge when we compare policy interest rates under flexible inflation targeting to the alternative make-up strategies being considered. Fed and academic models suggest the economy returns more quickly to a steady state following a downturn if central banks opt for make-up strategies. Interest rates would likely stay lower for longer than under the present policy framework. If the Fed had adopted a make-up strategy after the financial crisis, it would probably not yet have started to raise rates from post-crisis lows. Macroeconomic volatility could decrease as the risk of a severe economic downturn diminishes. And the risk of asset bubbles could increase.

Fed Chair Jerome Powell has said factors weighing on core U.S. inflation are "transitory." Our Inflation GPS supports this view. We expect the Fed to keep rates on hold for an extended period, unless an unexpected escalation in trade tensions creates material risks to growth. If the Fed implements a make-up strategy, it might help reduce the risk of deflation and the risk of a recession deepening into a full-blown depression, though we believe more radical measures would be needed to deal with a recession. These reduced risks – along with lower-for-longer rates and higher long-term inflation expectations – would likely support risk assets in the near term. But any market impact may be diluted if the change is billed as a tweak to the Fed's current framework.

2 Week in review

- President Trump's threat of tariffs on Mexico added fuel to a slide in equity markets and drop in government bond yields on jitters over trade tensions and the potential drag to global growth. German Bund yields hit all-time lows. The yield curve between the U.S. three-month Treasury bill and the 10-year Treasury note inverted to its lowest level since August 2007.
- China announced a temporary takeover of Bank of Baoshang, citing credit risk – its first takeover of a bank in around two decades. Separately, Chinese state media discussed a potential escalation of trade tensions: the possibility that China could limit the supply of rare earth minerals to the U.S. China's official May PMIs showed shrinking factory activity but resilient services growth.
- The search for new European Commission, European Council and European Central Bank (ECB) presidents is underway following the European Parliament elections. We see a rising risk of a standoff between Italy and the EU given Italy's breach of EU fiscal rules. The EU Commission has already stated that Italy remains at risk of disciplinary process over its fiscal trajectory.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-2.6%	10.7%	3.8%	2.1%
U.S. Small Caps	-3.2%	9.3%	-9.0%	1.6%
Non-U.S. World	-1.0%	7.5%	-5.8%	3.3%
Non-U.S. Developed	-1.8%	8.0%	-5.3%	3.5%
Japan	-1.2%	4.0%	-9.6%	2.6%
Emerging	1.2%	4.2%	-8.3%	2.8%
Asia ex-Japan	0.1%	3.9%	-10.8%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	1.2%	4.2%	6.3%	2.1%
U.S. TIPS	1.3%	5.2%	4.4%	2.3%
U.S. Investment Grade	0.9%	7.2%	7.4%	3.4%
U.S. High Yield	-0.5%	7.5%	5.5%	6.6%
U.S. Municipals	0.4%	4.7%	6.4%	2.1%
Non-U.S. Developed	0.3%	2.0%	0.4%	0.7%
EM $ Bonds	0.2%	7.7%	7.5%	6.0%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-6.1%	19.9%	-16.9%	$ 64.49
Gold	1.6%	1.8%	0.6%	$ 1,306
Copper	-2.1%	-2.3%	-14.9%	$ 5,830

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.3%	-2.6%	-4.5%	1.12
USD/Yen	-0.9%	-1.2%	-0.5%	108.28
Pound/USD	-0.6%	-1.0%	-5.0%	1.26

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 May 31, 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.

3 Week ahead

June 3 China Caixin PMI

June 4-5 Federal Reserve Bank of Chicago conference on "monetary policy strategy, tools, and communication practices"

June 5 U.S. ISM non-manufacturing PMI

June 6 ECB meeting and press conference

June 7 U.S. employment report; Germany industrial production

Central bank policy will be in focus this week. Markets will be looking for signs from the ECB policy meeting and press conference about whether the central bank's policy outlook is changing, with a modified forward guidance a likely first step. The central bank could set the stage to push out its current guidance that rates will remain on hold "at least through" the end of 2019. Elsewhere, Fed officials and academics will discuss alternative policy tools and other topics at a conference hosted by the Chicago Fed. In macro news, another solid U.S. payrolls report could help assuage recent growth worries that have sent benchmark U.S. Treasury yields to their lowest since 2017.

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, but still see the bonds as important portfolio diversifiers. We see recent moves lower in yields as excessive and advocate patience before increasing exposure. We prefer shorter-dated and inflation-linked bonds and expect a gradual yield curve steepening, driven by still-solid U.S. growth and the Fed's stated willingness to tolerate temporary inflation overshoots.
	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	—	Increased demand for income amid stable monetary policy, signs of more conservative corporate behavior and constrained supply remain supportive. We prefer an up-in-quality stance overall, but recent spread widening may also offer an attractive opportunity in BBB-rated credits. We favor bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. European sovereign bonds offer an attractive income opportunity for U.S.-dollar based investors on a currency-hedged basis.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income, yet valuations are relatively rich after a rally this year. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to its U.S. counterparts.
	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	—	We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia. Portfolio rebalancing could cause material capital inflows into China, as the country opens its markets to foreign capital.
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.

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