Weekly commentary

BlackRock

Dec. 02, 2019

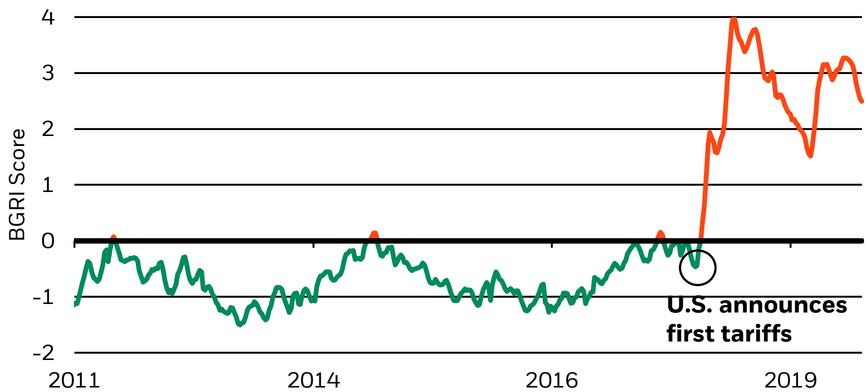
Taking stock of our 2019 views

- We identified the protectionist push as a key market driver this year but we did not foresee the massive move down in global yields.
- We see growth stabilizing and gradually picking up over the next 6 to 12 months thanks in part to loose financial conditions.
- Markets will focus on fresh U.S. manufacturing and jobs data for signs that the worst of the economic slowdown is behind us.

In 2019 the key drivers of global markets have been trade tensions and central bank easing, in our view. We were early to see that a protectionist push would hurt the industrial cycle and business investment — a key reason for our global growth downgrade. And we were correct to say that government bonds would play a crucial role as ballast during equity sell-offs even at low yields. But we did not see such a strong and persistent flight to safety and the unusual synchronized easing pivot from central banks at this advanced stage in the expansion.

Chart of the week

BlackRock Geopolitical Risk Indicator for global trade tensions, 2011-2019



Source: BlackRock Investment Institute, with data from Refinitiv. Data as of November 22, 2019. Notes: 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 Refinitiv 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.

We said that geopolitics and trade disputes would be a major driver of asset prices and volatility in 2019. This has played out, as seen in the chart above. Our BlackRock Geopolitical Risk Indicator for trade tensions shows that market attention to the protectionist push picked up through the year. It remains elevated, even after the U.S. and China talk up phase-1 trade-deal progress. We see a temporary truce in 2020 as likelier than not. Even if a deal isn't signed this year or early next, market participants may be happy if the current détente is preserved and tariffs scheduled for Dec. 15 are postponed. Risks remain: the shifting sands of domestic politics in both countries, including around the situation in Hong Kong, could change the calculus currently favouring a truce.

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BlackRock **Investment** Institute

Central banks have eased policy with the aim of offsetting the trade shock and sustaining the economic expansion. Yet we did not see this coming in our 2019 outlook given the late stage of the business cycle, with interest rates low, inflation subdued and consumers in strong shape. The surprising force of this dovish tilt has made it a big driver of markets, becoming one of our investment themes early in the year. As global bonds have rallied, yields have fallen in some places and tested the lower limits of central bank policy rates. Central bank easing, declining bond yields and strong risk asset markets have led to the recovery of our Financial Conditions Indicator. This now suggests that global growth should pick up over the next 6-12 months. Especially in Europe and Japan, monetary policy may have reached its limit in stoking growth and an unprecedented mix of fiscal and monetary policy will be needed if and when the next downturn arrives.

Elevated macro uncertainty in the late stage of the cycle reinforced our call for building portfolio resilience. Even at low yields, we said that bonds would play a key role in protecting portfolios against equity sell-offs. This happened in May and August. Yet we did not see how low rates would fall from already depressed levels. U.S. Treasuries rallied more than we anticipated, even though market expectations for aggressive Federal Reserve easing and for a recession were excessive, as we identified. The plunge of bond yields to new lows earlier this year amounts to a paradigm shift that is challenging the role of some government bonds as ballast in portfolios given how close yields are to their effective lower bound.

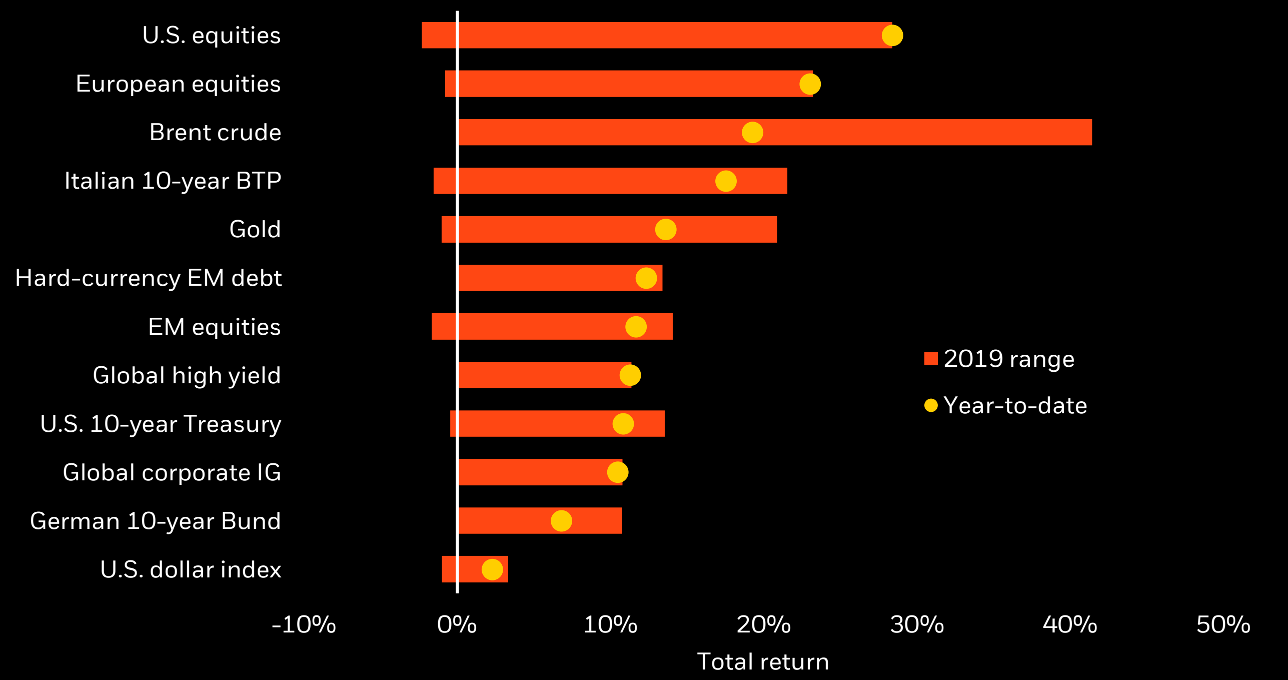
We were correct to take a modestly risk-on stance during the second half of 2019. Yet we were neutral on global duration and should have been overweight given the bond rally. We were right to stay overweight U.S. equities as a way to play our up-in-quality view, and the quality factor also outperformed. We missed the boost that Japanese equities would get starting in September from the lull in the protectionist push, but were right to underweight emerging market (EM) equities given their vulnerability to U.S.-China trade tensions. We were overweight EM debt because of the high yields on offer, and were positive on euro area bonds – especially in the periphery – on the prospect of ECB stimulus. Both outperformed. We will revise some of our asset views in our 2020 outlook as we re-evaluate macro and market drivers on a tactical horizon.

Market backdrop

A perceived lull in geopolitical frictions has boosted risk assets. We are on the watch for more signs that global manufacturing may be bottoming out, as well as signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing. We see the dovish pivot by major central banks as having run its course for now. Monetary policy is no cure for the weaker growth and firmer inflation pressures that may result from sustained trade tensions. We expect growth to stabilize and gradually pick up over the next 6 to 12 months thanks in part to loose financial conditions. See our macro data dashboard.

Assets in review

Selected asset performance, 2019 year-to-date and range



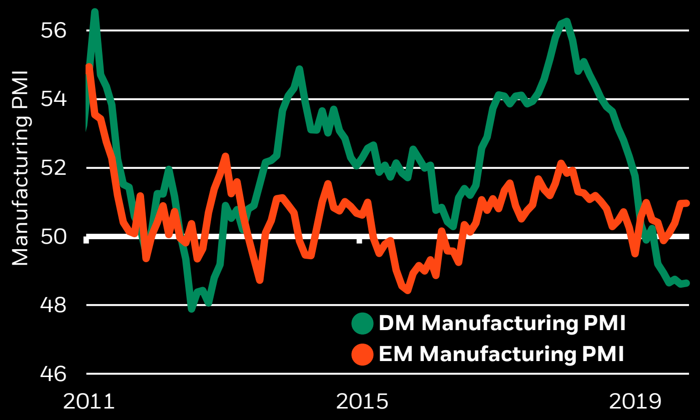
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2018, and the dots represent year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S. , German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

Economic activity – especially manufacturing – has been slowing over the past two years in developed markets (DM). In 2019 – for the first time since the European debt crisis – the aggregate DM manufacturing PMI has been consistently below the emerging market (EM) equivalent. This is unlikely to change in the short term. Flash PMIs for November in the U.S. and Europe suggested that the worst of the deceleration may have passed. Germany's manufacturing PMI rose and the overall euro area index inched up. Both remained in contractionary territory. Manufacturing activity accelerated in the U.S., helped by the end of auto strikes. Further improvement in the manufacturing cycle is likely. Financial conditions are accommodative and there are signs of a trade détente. Yet the DM manufacturing PMI may not rise back above the EM PMI soon. The IMF expects a faster rebound in the emerging economies in 2020 than in the developed world and the latest round of PMIs support this theme.

Trading Places

EM and DM manufacturing PMIs, 2011-2019



Sources: BlackRock Investment Institute and IHS Markit, with data from Refinitiv Datastream, November 2019. Notes: The chart shows the composite IHS Markit manufacturing purchasing managers' index (PMI) for developed markets and for emerging markets.

Investment themes

1 Protectionist push

- U.S. and China negotiators are working toward a "Phase 1" trade deal. Agreement has so far proven elusive due to additional demands – including tariff rollbacks by China and language on forced technology transfers by the U.S. – as well as a bill relating to Hong Kong that President Trump has now signed into law.
- We see a temporary truce in 2020 as likelier than not. Both sides have incentives that point toward a pause, and China has so far compartmentalized trade talks from broader political differences with the U.S. A key milestone will be Dec. 15, the date scheduled for the next round of U.S. tariff increases.
- The likelihood seems to have risen of a revised North American trade pact being ratified soon.
- Yet persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle — a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- Risks of a no-deal Brexit have diminished. Yet a general election on Dec. 12 has created uncertainty on what follows.
- **Market implication**: We favor reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- Central banks have eased policy significantly with the aim of offsetting the trade shock and sustaining the economic expansion in the face of a manufacturing recession.
- We expect growth to stabilize over 6-12 months and see a mild pick up thanks in part to loose financial conditions and a manufacturing recovery. This should take the reins from monetary policy in supporting risky assets.
- We believe the Federal Reserve and other central banks are done with policy easing barring other shocks. We don't expect China to provide major stimulus as its economy slows further, reflected in last month's small rate cut.
- The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct impact of tariffs and in the long term due to the hit to production capacity, complicating the case for policy easing.
- We believe policymakers should lay the groundwork for a credible plan to navigate the next economic shock that includes unprecedented coordination between monetary and fiscal measures. We lay out the contours of such a framework in *Dealing with the next downturn*.
- **Market implication**: We like U.S. equities and EM debt. We are tactically overweight euro area government bonds: a relatively steeper yield curve brightens their appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- This year's sharp shift on monetary policy and interest rate expectations has pushed some bond yields near levels we consider as their lower bound, implying less room to fall during risk asset sell-offs.
- A weakening or breakdown of the negative correlation between stocks and bonds could also undermine the portfolio ballast role of government bonds.
- **Market implication**: We prefer U.S. Treasuries over German and Japanese government bonds on a strategic basis.

Week ahead

Dec. 02 – Dec. 06 – Data releases this week in the U.S. should provide further insights on whether the worst of the economic slowdown is behind us. We will watch ISM PMIs to see if the manufacturing slowdown is bottoming out and U.S. non-farm payrolls for a sign that consumer momentum is maintained after a positive surprise last month. U.S. growth has been slowing this year but we expect it to pick-up in 2020.

Asset views

Views from a U.S. dollar perspective over a 6-12 month horizon

Asset class		View	Comments
Equities	**U.S.**	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like min-vol and quality, which have historically tended to perform well during economic slowdowns.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	**U.S. government bonds**	▼	We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	—	Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis' tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key parts of our income thesis.
	European sovereigns	▲	The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for euro area investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We like EM bonds for their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina's woes) and in countries not directly exposed to U.S.-China tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight   – Neutral   ▼ Underweight

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