Weekly commentary

BlackRock.

March 16, 2020

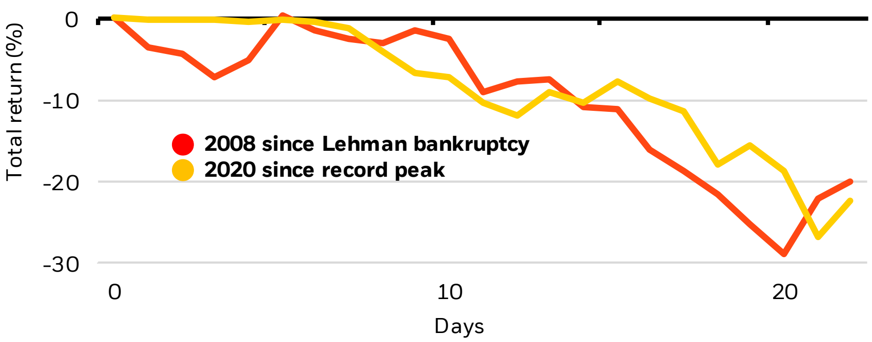
Looking through the market turmoil

- A decisive and coordinated policy response should prevent the coronavirus shock from sparking a 2008-style crisis.
- Government bonds have served their role as portfolio ballast in the risk asset selloff, but this role looks increasingly challenged by low yields.
- Monetary and fiscal actions to cushion the blow have begun, including the Fed cutting rates to near zero and announcing bond purchases.

The coronavirus outbreak is set to deliver a sharp and deep economic shock. Market moves are reminiscent of the 2008 crisis, but we don't think this is a repeat. Stringent containment and social distancing policies will bring economic activity to a near standstill, but provided aggressive fiscal and monetary policy actions are taken to bridge businesses and households through the shock, activity should return rapidly with little permanent economic damage.

Chart of the week

Developed market equity performance, 2020 vs. 2008



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, March 2020. Notes: Data are as of March 13, 2020. The yellow line shows the performance of MSCI World Total Return Index since it closed at a record high on Feb. 12, 2020. The orange line shows the performance of the index over the same number of trading days since Sept. 12, 2008, the last trading day before Lehman Brothers declared bankruptcy.

The market's gyrations have sparked memories of 2008. Developed market stocks have fallen as much as 27% from the February peak, but pared losses on Friday. The magnitude of the selloff is similar to that in the aftermath of Lehman Brothers' bankruptcy in 2008. See the chart above. We have also seen sharp swings in fixed income, with U.S. Treasury yields first hitting record lows and then closing up on the week. Crude oil prices last week posted their largest single-day decline since the Gulf War amid a price war between Russia and Saudi Arabia. What will it take to stabilize markets? A decisive, preemptive and coordinated policy response is key, in our view. This includes aggressive public health measures to stem the outbreak, as well as coordinated monetary and fiscal easing to prevent disruptions to income streams – especially to households and smaller firms - that could cause lasting economic damage. We see encouraging signs on both sides of the Atlantic that such a monetary and fiscal response is underway.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The evolution and global spread of the coronavirus outbreak are highly uncertain. What we know: Containment measures and social distancing mechanically bring economic activity to a halt, as seen in China and Italy. There is a strong incentive to enact such measures proactively to slow the growth of coronavirus infections, and France and Spain over the weekend joined Italy in imposing drastic lockdown measures. The impact on economic activity will likely be sharp – and deep. Yet we believe that the sharper the containment measures taken and the deeper the economic hit in the near-term, the more confident we should be about the rebound after such measures are lifted. We see the shock as akin to a large-scale natural disaster that severely disrupts activity for one or two quarters, but eventually results in a sharp economic recovery.

The key assumption behind this view: Policy makers act to stabilize economies and forestall any cash-flow crunches that could lead to financial stresses and tip the economy into a financial crisis. The Fed on Sunday cut rates to near zero, announced up to $700 billion in bond purchases and other measures to ensure the proper functioning of markets, and set up arrangements with other central banks to make U.S. dollar funding available. The White House earlier unlocked disaster funding, and Congress is set to pass a bill to cover health care and paid leave for some workers. A more sizable fiscal response is possible amid growing recognition in Congress that this is needed. The UK last week delivered on a coordinated set of measures including a Bank of England rate cut and a budget that included relief to affected sectors. This, and similar moves by Canada last week, is the type of coordinated monetary and fiscal action that we have flagged a need for in dealing with the next downturn. The European Central Bank provided material relief to the banking system at the heart of financing the euro area economy, and several European nations signaled they will significantly loosen fiscal policy. Yet the ECB's move was not the "whatever it takes" package markets had expected, and bond yields of some peripheral nations jumped.

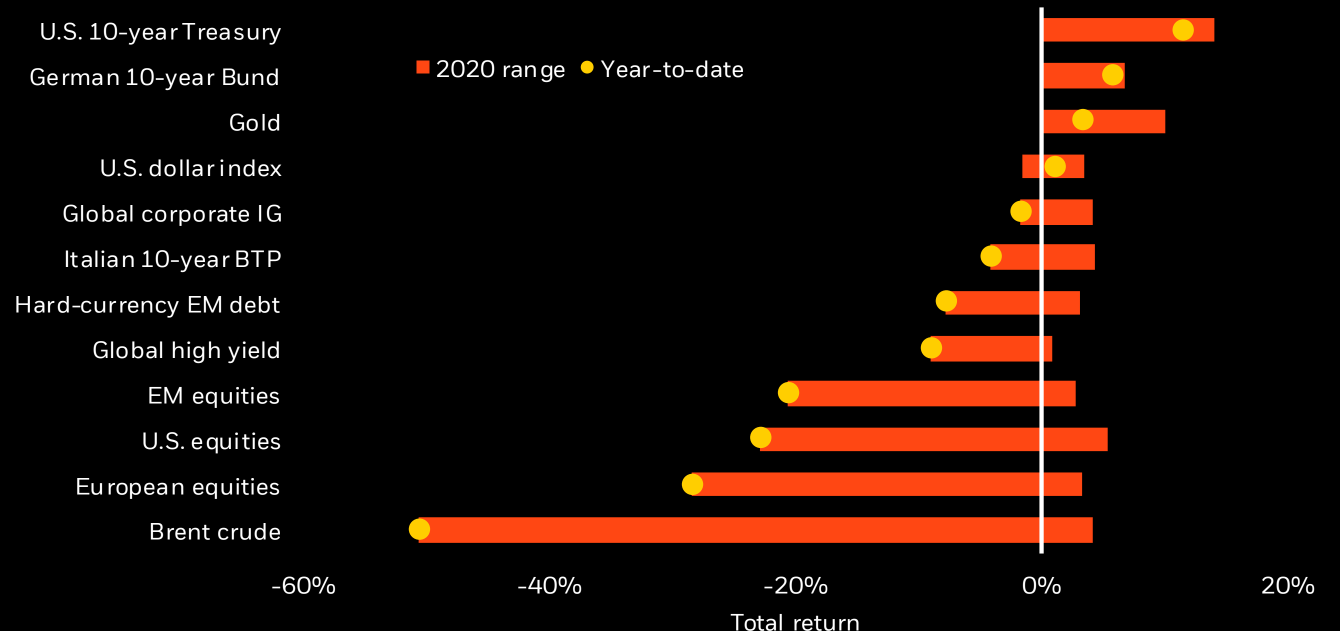
We have recently downgraded our stance on risk assets to benchmark weight due to material uncertainties associated with the outbreak and its impact, including the effectiveness of public health measures and how long the threat of the virus will linger. Large declines in yields have further diminished the cushion that government bonds have to offer against risk-asset selloffs, reducing their portfolio diversification benefits. We still prefer U.S. Treasuries over lower-yielding peers for portfolio ballast, but acknowledge increasing risk of snapbacks from near historically low yield levels.

Market backdrop

The contours of a policy response to coronavirus are starting to take shape as the outbreak – and related containment measures – propagates across the globe. A credible response will require a joint effort between fiscal and monetary policy (see the following page for more). To date, the policy response has failed to stabilize markets, with U.S. equities last week registering their sharpest one-day decline since Black Monday of 1987 and European equities suffering their largest daily loss in history.

Assets in review

Selected asset performance, 2020 year-to-date and range



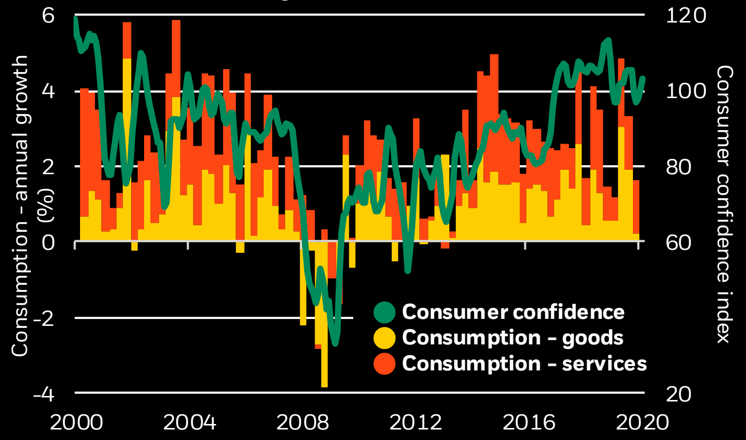
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, 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

U.S. consumer spending has underpinned the economy in recent years. But the shock caused by the coronavirus outbreak could be sizable. A 50-year low in the unemployment rate and strong real wage growth underscores that consumers started 2020 in a position of strength. Most of the growth in personal consumption after 2008 has been on services spending, which has remained relatively stable while goods consumption has fluctuated. Spending growth has gone hand in hand with strong surveys of consumer confidence. And the household saving rate is close to its post-crisis high. Yet consumers could start getting worried by the prospect of large disruptions to day-to-day life, and the loss of employment or business revenues. Even before the outbreak, household debt levels reached a 14-year high at the end of 2019. The safety net for U.S. workers who fall ill or lose their jobs in the wake of the outbreak should be reinforced, in our view.

Consumer resilience

U.S. consumer spending and confidence, 2000-2020



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and Conference Board, with data from Refinitiv Datastream, March 2020. Notes: The bars show the breakdown of real U.S. personal consumption expenditure in services (orange) and goods (yellow) in seasonally adjusted annual rates of growth on a monthly basis. The green line shows the three-month moving average of Conference Board consumer confidence expectations for the next six months.

Investment themes

1 Growth downshift

- The coronavirus containment measures are set to deliver a sharp and deep economic shock. This may push Japan and the euro area into a technical recession, or two consecutive quarters of economic contraction.
- The U.S. will likely prove more resilient. U.S. consumer spending has underpinned the expansion. Services spending has been steady, though it will be partly hampered by increasing containment measures.
- We expect a recovery in activity once disruptions dissipate, but their depth and duration are highly uncertain. This could weigh on consumption and investment.
- The main risk to our view: a broadening of the outbreak is not met with a decisive policy response, triggering a premature end to the cycle.
- We still see a slowdown macro regime for 2020, with the alternative regime between recession and stagflation – and goldilocks is less likely.
- **Market implication**: We downgrade our moderate pro-risk stance and turn neutral on equities and credit.

2 Policy action

- A decisive, pre-emptive and coordinated policy response is required to avoid the disruptions to income streams and financial flows that could cause persistent economic damage.
- Simply using the limited monetary policy space left could quickly put the macro focus on the lack of tools left – and thus backfire.
- A joint effort between monetary and fiscal policy is required to avoid a raft of financial failures at the grassroot level due to demand shortfalls, production disruptions or payment delays that can all lead to cash flow squeezes. That is why any solutions will need to involve "going direct" with policy – that is, more directly relieving the cash flow pressures facing some sectors of the economy.
- The Federal Reserve and Bank of England have delivered emergency rate cuts, with the BoE teaming up with the UK Treasury to deliver a joint response. The European Central Bank unveiled additional financing for banks to support lending, but the response underwhelmed markets and caused peripheral spreads to widen. The Bank of Japan doubled its planned purchases of ETFs and REITs, pledged to buy corporate bonds and commercial paper and set up new lending facilities for SMEs while holding rates steady and maintaining its yield curve control policy.
- In the U.S., fiscal action is likely to come in phases, with the first phase being targeted and later phases involving broader stimulus.
- **Market implication**: Coupon income is crucial as bond yields have plunged to new lows.

3 Rethinking resilience

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds.
- Our preference for U.S. Treasuries and Treasury Inflation-Protected Securities as portfolio ballast mostly worked in the virus-related equity volatility, aside from a few days when stocks and bonds both declined in the market stress.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a new phenomenon that will carry a return advantage over years and decades.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

Week ahead

Mar. 16	China industrial output and retail sales
Mar. 17	U.S. industrial output and retail sales; Germany ZEW economic sentiment
Mar. 19	Philadelphia Fed manufacturing business outlook survey

After a flurry of interest rate cuts by global central banks, growth data may return to the spotlight this week as markets grapple with the extent of the economic fallout from the coronavirus outbreak. China's industrial output and retail sales data for February likely will show a slump.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, March 2020

Asset	Underweight	Neutral	Overweight
Equities		●	
	We downgrade global equities to neutral. The coronavirus outbreak is disrupting economic activity and supply chains. The outbreak also poses risks to corporate earnings, in our view. Accommodative monetary policy is a support.		
Credit		●	
	We cut our overall view on credit to neutral. Downside risks and increased uncertainty around the economic outlook reduce our preference for risk assets. We could also see a risk of temporary liquidity crunches. We remain neutral as coupon income is king in a world starved for yield, especially at a time government bond yields are hovering near record lows.		
Government bonds		●	
	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market sell-offs and a snap-back in yields from historically low levels.		
Cash		●	
	We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.		

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

Granular views

Change in view
Previous New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, March 2020

	Asset	Underweight	Overweight	
Equities	United States			The U.S. market's relative quality bias is a support. Uncertainty around the 2020 election has lessened with reduced risk of maximally divergent policy agendas between the two parties.
Equities	Euro area			We maintain European equities at underweight. We see greater upside elsewhere in an eventual cyclical recovery – and markets look to have priced in easing by the European Central Bank.
Equities	Japan			We see Japanese equities benefit most from an eventual global manufacturing recovery and a lull in trade tensions. We see near-term risks to growth due to the virus outbreak and a sales tax increase.
Equities	Emerging markets			We see EM equities as beneficiaries from the global recovery once the current shock dissipates. EM central banks are likely to stay on their easing paths, supporting growth and equity markets.
Equities	Asia ex-Japan			We hold Asia ex-Japan equities at neutral amid prospects of a growth uptick, even if delayed. We see China's economy eventually recovering from disruptions tied to the coronavirus outbreak.
Equities	Momentum			We upgrade momentum to neutral. The factor has outperformed amid the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend-paying bond proxies.
Equities	Value			We downgrade value to underweight. Value tends to perform best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
Equities	Minimum volatility			We upgrade min-vol to overweight. We prefer its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
Equities	Quality			We hold quality as an overweight. We like that it tends to be resilient in late-cycle periods, despite their relatively high valuations.
Fixed Income	U.S. Treasuries			We maintain U.S. Treasuries at neutral, preferring the front end of the curve. Yet we acknowledge the risk of a sharp snapback in yields from record lows.
Fixed Income	Treasury Inflation-Protected Securities			The asset class has underperformed sharply on coronavirus fears and the downward price shock to oil. We maintain our overweight given extremely low levels of inflation implied by pricing in the U.S. inflation-linked market.
Fixed Income	German bunds			We remain underweight bunds as they continue to provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
Fixed Income	Euro area peripherals			We remain underweight. Despite sharp underperformance versus bunds, yields and spreads are insufficient to compensate investors given increased volatility and the unwillingness of the ECB to expand asset purchases.
Fixed Income	Global investment grade			We keep global IG credit as an underweight. The sector looks unattractive despite a recent sharp widening in spreads, due to slowing earnings, relatively high leverage, low coupon rates and considerable interest rate risk.
Fixed Income	Global high yield			We maintain an overweight in global high yield for its income potential, despite recent underperformance. We avoid the energy sector as a lower for longer oil price challenges such as dealing with a near-dated maturity wall.
Fixed Income	Emerging market – hard currency			We move hard currency debt to neutral, preferring local markets for our fixed income EM exposure.
Fixed Income	Emerging market – local currency			We remain overweight local-currency EM debt, despite recent negative performance driven by a stronger U.S. dollar. With yields above 5% the asset class looks attractive – and currency depreciation appears excessive.
Fixed Income	Asia fixed income			We maintain an overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We expect solid demand from local Chinese and regional investors.

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