Weekly commentary

BlackRock

March 2, 2020

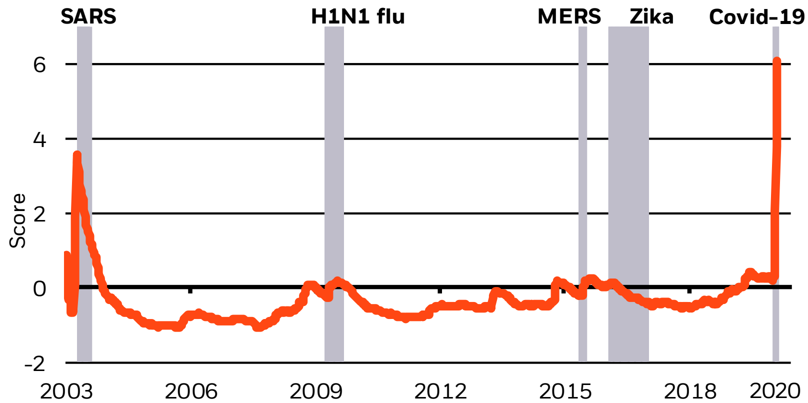
Virus outbreak turns us cautious

- We see the spreading coronavirus outbreak and related containment measures causing a downshift in the global growth outlook for 2020.
- We shift our moderate pro-risk stance to a neutral position due to the many uncertainties associated with the outbreak and its impact.
- This week's data may show weakness caused by the outbreak and we may get an early read on the Democratic U.S. presidential candidate.

The spread of the coronavirus beyond China has opened up a new global dimension to the epidemic – and potential for a sharper economic drag from efforts to contain it. We expect the economic expansion to remain intact, albeit on a lower track. We see a sharp rebound once potential disruptions dissipate, yet the unknown depth and duration of the shock add material downside risks. As a result, we have pulled back our moderately pro-risk stance to benchmark weights.

Chart of the week

Market attention to global disease outbreaks, 2003-present



Sources: BlackRock Investment Institute, with data from Refinitiv, February 2020. Notes: We identify specific words related to major disease outbreaks since 2003, then use text analysis to calculate the frequency of their appearance in the Refinitiv Broker Report and Dow Jones Global Newswire databases. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average level over its history from 2003 up to that point in time. A score of one means the attention level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.

Global markets have been gripped by fears over the impact of the epidemic. Market attention to the outbreak has shot up to levels higher than those seen during the SARS epidemic in 2003, according to our text analysis of broker reports and the financial press. See the chart above. We see the drag on economic activity threatening to push some developed economies – such as Japan and the euro area – toward the brink of a technical recession (defined as two consecutive quarters of economic contraction), even though we don't foresee a recession in the U.S. or globally. A policy pause is no longer our base case. A sustained tightening of financial conditions or impairment to market liquidity could be met with coordinated policy easing by major central banks but many, such as in the euro area and Japan, have limited policy space. Fiscal policy will likely also be an important part of the toolkit, especially in China.

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The level of economic activity is likely to step down for 2020 as the outbreak is becoming an increasingly global public health threat, we believe. Disruptions are already spreading across continents – and may further decelerate economic activity. We expect a rapid rebound in activity once disruptions dissipate, but still see a great deal of uncertainty around the extent and pace of the deceleration. These include the outbreak's eventual geographical reach, the public health measures taken in response, and how long the outbreak and these measures last. One key signpost to watch in the near term: How successful will China's effort to restart its economic activity be – and can it avoid another round of mass infection as workers return? This may provide insight on the potential duration of the outbreak - and its economic impact – elsewhere.

Our base case: We see the drag on economic activity as temporary, with underlying economic fundamentals still supportive of the global economic expansion. The risk to this view is that the hit to economies from the outbreak and containment measures undermines fundamentals and triggers the end of this cycle. We are on the lookout for any signs of a liquidity crunch or deterioration in financial conditions. Many small-and medium-sized enterprises in Europe and China, among other regions, could be susceptible to a cash flow crunch if the outbreak endures, and easy financial conditions have been crucial in supporting global growth since late last year. We see material risks to global supply chains, concentrated in tech, autos and capital goods. This outbreak may further compel companies to reassess their supply chains, which have already come under pressure from global trade tensions in recent years. Over time, these supply shocks could weigh on growth, increase production costs, and pressure profit margins lower and inflation higher.

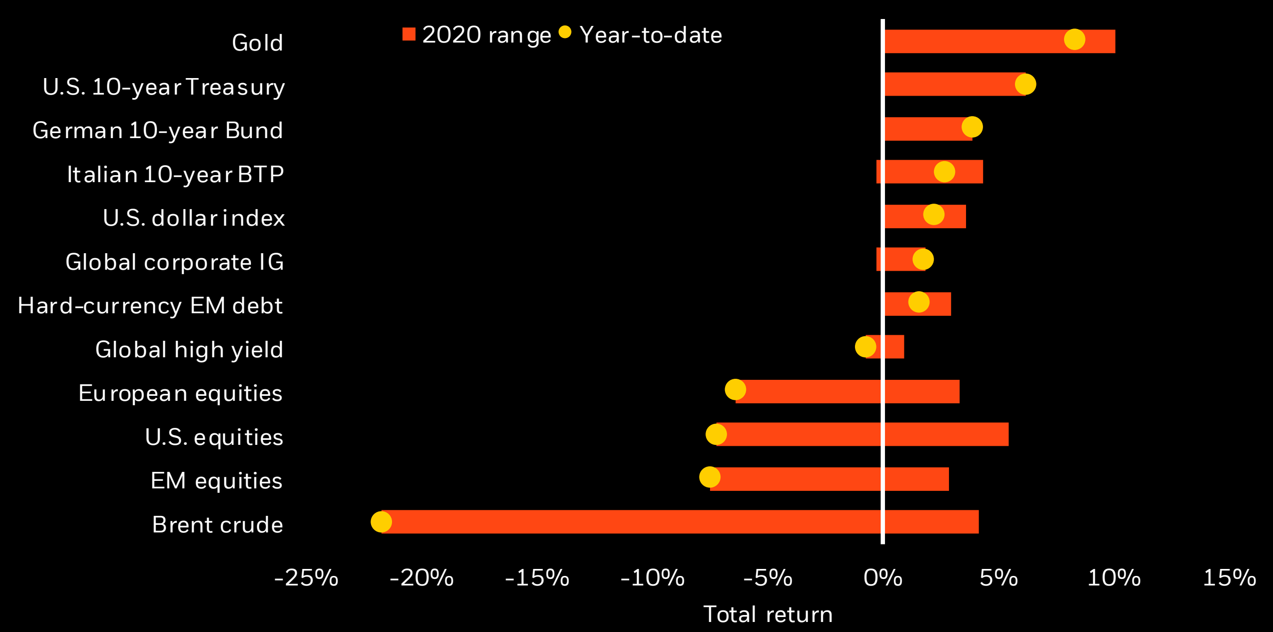
We still view the U.S. as in a late-cycle slowdown regime. The impact of broader monetary and fiscal policy responses may be difficult to gauge during the outbreak, but it's clear that liquidity support and additional public health spending will be necessary. An additional source of financial market uncertainty is the wide divergence between the policy agendas of the parties in the U.S. presidential election. We reduce our overweight equity and credit exposures to benchmark weights, and advocate portfolio resilience through the quality and minimum volatility equity factors, the ballast properties of government bonds – especially U.S. Treasuries – and cash. We are also reviewing our granular regional equity and fixed income views.

Market backdrop

Worries about the coronavirus spreading beyond China have knocked most equity markets into negative territory for the year, while many government bond yields hover near record lows. We see containment measures offsetting the positive impact of a pause in trade tensions and accommodative financial conditions. We are likely to see renewed weakness in global manufacturing due to the virus' impact. A policy response looks increasingly likely, even as many major central banks have limited room to move. Questions are: How much easing, how soon it will take place, and how coordinated it will be globally.

Assets in review

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



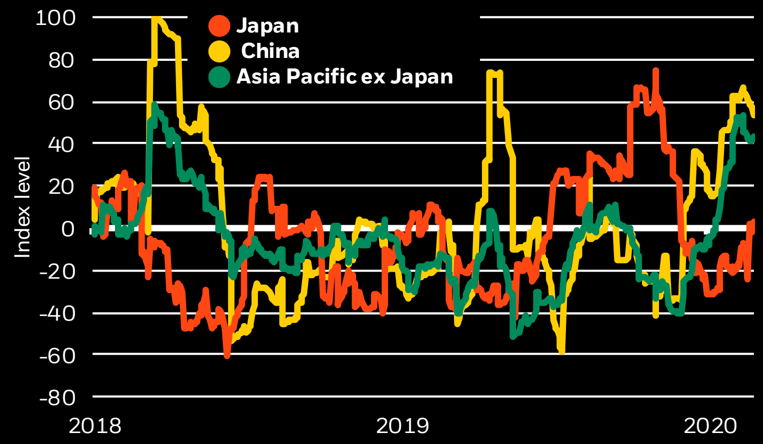
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end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

The effects of the coronavirus outbreak are starting to ripple out from China. Recent data in Asia have missed market expectations. And Japan faces the prospect of a technical recession as the impact from the virus outbreak piles on top of the sharp drop in fourth-quarter GDP after the sales tax increase in October. Japan had been trailing market expectations even before the virus outbreak. And the economic surprise indexes for China and the rest of Asia have started to drop again after some positive surprises over the turn of the year. South Korean imports from China plunged in the first 20 days of February and Japan's February flash PMI pointed to a steep fall in services activity. This highlights two ways that spillovers from China occur: along supply chains (Vietnam, Thailand and South Korea risk missing imported inputs into production) and via weaker demand – especially a hit to tourism activity. Thailand, Hong Kong and Singapore may see a severe drop in services exports.

Jaded Japan

Citi Economic Surprise indexes, 2018-2020



Sources: BlackRock Investment Institute and Citigroup, with data from Refinitiv Datastream, February 2020. Notes: The chart shows the Citi Economic Surprise Index for China, Japan and Asia Pacific excluding Japan. The index measures the pace at which economic indicators are coming in ahead of or below consensus forecasts.

Investment themes

1 Growth downshift

- We see the coronavirus outbreak and containment measures causing near-term disruption to global economic activity. This may push Japan and in the euro area to the brink of technical recession.
- We expect a recovery in activity once disruptions dissipate, but the depth and duration of the trough are highly uncertain and these unknowns could weigh on consumption and investment.
- The main risk to our view: a broadening of the outbreak triggers a premature end to the cycle.
- The macro impact thus far – within China and beyond – is primarily driven by China's extensive containment measures. Yet the spread of the outbreak to other regions threatens to broaden the economic fallout.
- Our macro regime work puts the U.S. business cycle in a slowdown regime – but we could see supply chain disruptions trigger a market-unfriendly mix of slowing growth and rising inflation over time.
- **Market implication**: We downgrade our moderate pro-risk stance and turn neutral on equities and credit.

2 Policy action

- Any further and sustained tightening of financial conditions will likely be met by additional easing by major central banks, although many, such as in Japan and the euro area, have diminished policy space.
- China has eased monetary policy as a first response to cushion the drag from the coronavirus outbreak.
- Fiscal policy will likely be part of the toolkit, with governments ramping up public health spending and providing relief to the hardest hit industries and regions.
- The U.S. and China have strong incentives to maintain the pause on their trade conflict, though there may be more turbulence ahead in global trade, particularly if U.S. trade measures shift to Europe.
- **Market implication**: Income streams are crucial in a slow-growth, low-rate world. We like EM and high yield debt.

3 Rethinking resilience

- Our preference for U.S. Treasuries and Treasury Inflation-Protected Securities as portfolio ballast worked during the recent virus-related equity volatility. The moves also confirmed that some developed market government bonds, such as German bunds, offer less diversification with yields near levels we consider to be their lower bounds.
- A weakening or breakdown of the negative correlation between returns of stocks and bonds could undermine the portfolio ballast role of government bonds.
- 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.
- Tensions over technology rivalry remain high between the U.S. and China. We believe markets are underestimating cyber risks ahead of the U.S. election. See our geopolitical risk dashboard.
- **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

March 2 U.S. ISM manufacturing purchasing managers' index (PMI); Jibun Bank manufacturing PMI

March 3 One-third of U.S. states vote for presidential nominees on "Super Tuesday."

March 4 China Caixin services PMI; U.S. ISM non-manufacturing PMI

March 6 U.S. nonfarm payrolls

We are likely to see renewed weakness linked to the coronavirus outbreak in global data due this week. Recent data in Asia have generally undershot market expectations, reversing a series of cyclical improvements seen since late 2019. In the U.S., the political spotlight will move to "Super Tuesday" and whether leading Democratic candidate Bernie Sanders can amass enough delegates to cement an commanding lead in the battle for the Democratic nomination.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, February 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. Equity valuations still look reasonable, and 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, although the bar for taking such action looks high in the U.S. and Europe. We favor regions that have policy space, such as the U.S.		
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, February 2020

	Asset	Underweight	Overweight	
Equities	United States			We keep U.S. equities at neutral. Rising uncertainty around the 2020 election and a wide range of policy outcomes may weigh on sentiment and prevent a repeat of outperformance.
Equities	Euro area	■■		We maintain European equities at underweight after a stretch of outperformance – and see greater upside in cyclical exposures elsewhere. Markets look to have fully priced in the ECB's easing.
Equities	Japan		■	We keep an overweight in Japanese equities. We see this market among those set to benefit most from a global manufacturing recovery and a lull in U.S.-China trade tensions.
Equities	Emerging markets		■	We keep an overweight in EM equities and see them as beneficiaries from the global recovery. 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. This offers shelter from any curve steepening triggered by stronger growth and some insulation against risk asset selloffs.
Fixed Income	Treasury Inflation-Protected Securities		■	The asset class has rallied amid the coronavirus outbreak, making an entry point less attractive now. We still see potential for higher inflation amid U.S. wage pressures and like TIPS in strategic portfolios.
Fixed Income	German bunds	■		We remain underweight bunds as they 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 hold an underweight in euro area peripheral government bonds. We see yields and spreads as insufficient to compensate investors for underappreciated political risks in the region.
Fixed Income	Global investment grade	■■		We keep global investment grade credit as an underweight. Valuations appear rich, and we see low coupon rates making the sector's income relatively unattractive on a risk-adjusted basis.
Fixed Income	Global high yield		■	We keep global high yield as an overweight, supported by stable monetary policy and the prospect of a growth inflection.
Fixed Income	Emerging market – hard currency		■	We still like hard-currency EM debt against a backdrop of dovish EM central banks, an improving growth outlook and a stable to somewhat weaker U.S. dollar. We prefer the high-yielders.
Fixed Income	Emerging market – local currency		■■	We hold local-currency EM debt as a high-conviction overweight. Coupons look attractive, and EM currencies could appreciate as DM central banks stick to easy policies.
Fixed Income	Asia fixed income		■	We maintain Asia fixed income as an overweight. Asian central banks have room to ease policy, and currency stability is a positive. Valuations have become richer, and we prefer up-in-quality exposures.

Note: Views are from a U.S. dollar perspective. 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.

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