Weekly commentary

Feb. 17, 2020

BlackRock

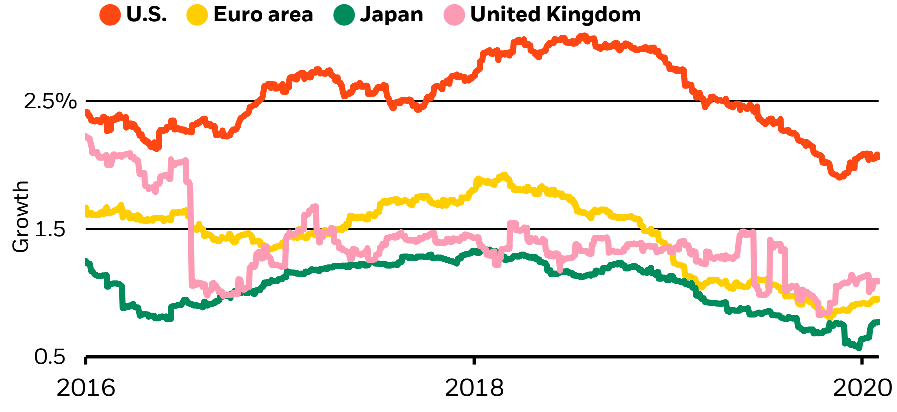
Testing our global outlook

- We see global growth edging higher in 2020, though the coronavirus outbreak has added uncertainties around the timing of the pickup.
- We retain our moderate pro-risk investment stance over the next six to 12 months, yet the pathway could involve greater volatility.
- This week's flash purchasing managers' index (PMI) data could show a temporary softening in manufacturing activity, reversing recent gains.

The February update to our Global Outlook reaffirms our expectation for global growth to edge higher this year, even as the coronavirus outbreak has introduced uncertainties. Past epidemics have seen V-shaped economic recoveries – a pattern we expect see this time as well. Yet the depth and width of the "V" are highly uncertain. This outbreak could be more disruptive than past ones because it could be more severe, and because of greater reliance on global supply chains.

Chart of the week

BlackRock Growth GPS for developed market economies, 2016-2020



Sources: BlackRock Investment Institute, with data from Consensus Economics, February 2020. Notes: The Growth GPS shows where consensus GDP forecast may stand in three months' time, shifted forward by three months. Forward-looking estimates may not come to pass.

Growth prospects have started to improve in key developed economies since late 2019. Our BlackRock Growth GPS, which aims to give a read of where consensus forecasts of real economic growth may stand in three months' time, has shown an inflection in growth expectations for the U.S., the euro area, Japan and the UK. See the chart above. Growth momentum was also starting to recover in emerging markets (EM) late last year. Yet the coronavirus outbreak has emerged as a principal risk to our global growth outlook. Economic growth and markets have historically responded with a V-shaped pattern to temporary disruptions caused by past epidemics, with the recovery in economic activity often fueled by the pent-up demand in retail and a restart of manufacturing sector. Yet key uncertainties around this outbreak may make history an unreliable guide. It is still too soon to gauge the magnitude and duration of this outbreak as well as its overall impact on the global economy.

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The short-term impact from the coronavirus outbreak – thus far mostly stemming from China's containment measures – will likely play out in coming quarters. Based on what we now know, we see it delaying, but not derailing, a growth uptick that should take root this year. China's central bank has already started to ease policy, and we are likely to see more support from Chinese authorities to shore up growth, yet an ongoing desire to rein in financial excesses leaves open the size and shape of the stimulus. Another key development to watch: How extensively will the outbreak spread beyond China?

The coronavirus outbreak may also pose medium-term risks. Potential disruptions to global value chains could drive up prices – and push companies that suffer from such disruptions to build up higher stockpiles and start to rethink prevalent just-in-time inventory management systems. This adds to the potential disruptions to global supply chains from trade protectionism. Over time, such supply shocks could lead to a change in the macro regime. One possibility: Growth slows and inflation rises. This might pressure the negative correlation between stock and bond returns over time, reducing the diversification properties of government bonds.

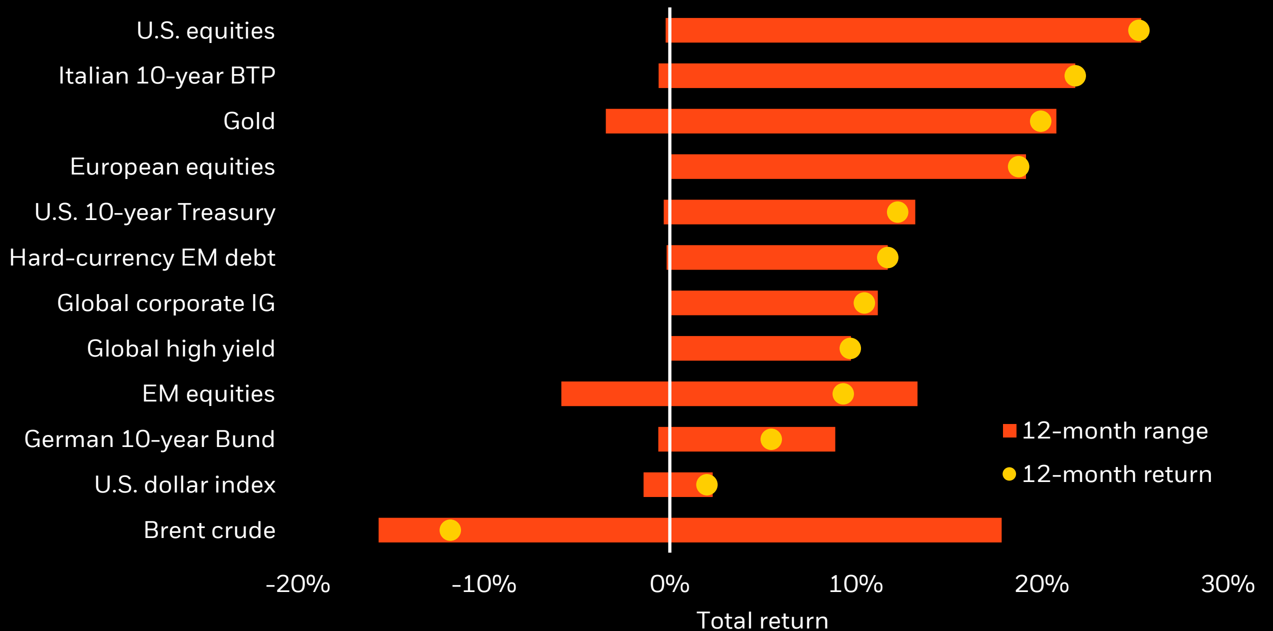
Our base case for the global economy in 2020 is still for a modest pickup in growth, with a slight rise in U.S. inflation pressures. This in turn limits recession risks. Financial vulnerabilities are climbing, but our overall gauge of vulnerabilities across the economy stands well short of its peaks ahead of the last recession. We still view this as a favorable backdrop for risk assets over a 6-12 months horizon, even considering the impact from the coronavirus outbreak. Yet many uncertainties around its severity, as well as potential economic and market impacts could make the path forward uneven. Over the same time horizon we still see potential for a bounce in cyclical assets, such as Japanese and EM equities, as well as EM debt and high yield. We see a neutral stance on U.S. equities as appropriate as growth recovers and uncertainties around the 2020 U.S. election intensify – despite their recent outperformance. We are underweight European equities and see greater upside in cyclical exposures elsewhere. We prefer short-term U.S. Treasuries on a tactical basis and like both long-term Treasuries and Treasury Inflation-Protected Securities (TIPS) as sources of resilience against potential regime shifts in strategic allocations, even as the recent rally in real rates has made an entry point less attractive now.

Market backdrop

Positive corporate earnings have limited equity losses triggered by worries about the coronavirus outbreak emanating from China and its potential economic impact. Moderating trade tensions and still accommodative financial conditions are supportive of growth. The lack of a clear leading U.S. Democratic presidential candidate underscores rising political uncertainty. We are likely to see renewed weakness in global manufacturing due to the virus' impact. We are monitoring the duration and severity of the outbreak, as well as the rise of cases outside China. We believe there may be a misalignment between the market's current assessment of the outbreak's impact and shorter-term risks around its geographic spread.

Assets in review

Selected asset performance in the past 12 months



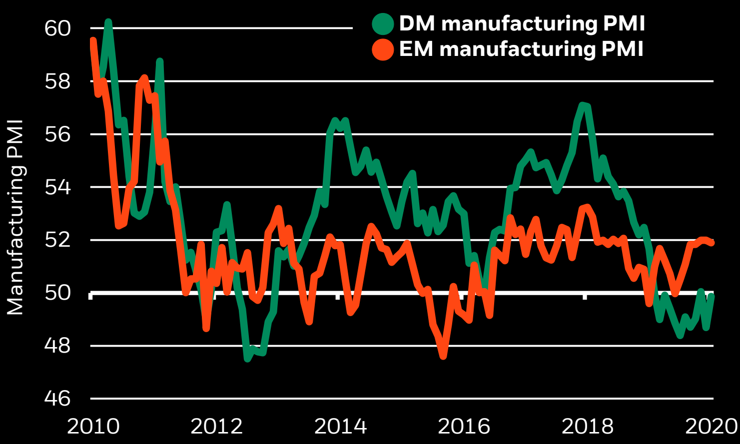
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2020. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared to 12 months earlier. 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

We believe emerging market (EM) momentum could be disrupted – not derailed – in the medium term, by the coronavirus. We expect the EM manufacturing PMI to remain above the developed market equivalent in the medium term. See the chart on the right. The immediate impact is likely to be felt hardest in China, as the authorities have responded with widescale restrictions on travel and production in affected areas. But neighbouring economies are at risk from shocks rippling out via reduced tourism and through global supply chains. If the rate of coronavirus infections begin to slow, and restrictions on movement and production are lifted soon, then the effect of the outbreak is likely to be short-lived. Economies have recovered quickly from outbreaks in the past – especially in manufacturing as producers try to make up for lost output. Services industries may find it harder to recoup lost sales (think of hotels, restaurants and tourism).

Emerging market momentum

EM and DM manufacturing PMIs, 2010-2020



Sources: BlackRock Investment Institute and IHS Markit, with data from Refinitiv Datastream, February 2020. Notes: The chart shows the aggregate flash IHS Markit manufacturing output purchasing managers' index (PMI) for developed markets and the aggregate for emerging markets.

Investment themes

1 Growth edges up

- We stick to our view that global growth will edge higher thanks to easier financial conditions, limiting recession risks.
- The growth mix should eventually shift as manufacturing recovers from coronavirus disruptions. We already see firming in interest rate-sensitive sectors, such as housing.
- The U.S. and China have strong incentives to maintain the pause on their trade conflict after agreeing to a limited "phase 1" trade deal, though there may be more turbulence. The U.S. adopted a revised North American trade pact. Both steps should allow global trading activity some breathing space, but U.S. trade measures could shift to Europe.
- We see greater uncertainty about China's economic outlook – and prospects for stimulus – due to the coronavirus outbreak. The macro impact thus far is primarily driven by China's aggressive containment measures.
- Our macro regime work puts the business cycle in a slowdown regime – but we could see a shift to a risk asset-friendly goldilocks regime or a market-unfriendly mild stagflation regime.
- **Market implication**: We maintain a moderate pro-risk stance and see potential for cyclical assets such as Japanese and EM assets to outperform tactically.

2 Policy pause

- We see economic fundamentals driving markets in 2020, and less scope for monetary easing and other policy surprises. The lagged effect of monetary policy easing is starting to filter through to economic activity.
- The Federal Reserve has reaffirmed that the bar for further policy easing is high. We believe there is too much focus on the Fed's balance sheet whose role now is primarily about keeping the fed funds rate on target.
- China has eased monetary policy as a first response to cushion the drag from the coronavirus outbreak.
- The policy debate is set to zoom in on a potential shift from monetary to fiscal stimulus. Any fiscal support in 2020 is likely to come from outside the U.S.: notably in Japan, as well as EM ex-China. We see greater focus on the role fiscal policy might play depending on the outcome of the U.S. election.
- The UK signaled a potential shift toward greater fiscal spending. A costly high-speed train line was approved, and a change of chancellor of the exchequer suggests a coming relaxation of the country's fiscal rules to limit deficits.
- Our base case is for little chance of meaningful global fiscal stimulus. Yet we acknowledge the UK government could spend more and the coronavirus outbreak could push China into greater stimulus than initially anticipated. Importantly, modest shifts toward fiscal easing may have outsized market impact.
- **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, work less well as diversifiers with yields near levels we consider to be their lower bounds.
- A focus on sustainability can help make portfolios more resilient. A commonly held view is that sustainable investing requires giving up potential returns – we don't think that's true.
- A weakening or breakdown of the negative correlation between returns of stocks and bonds could also undermine the portfolio ballast role of government bonds.
- Geopolitical tensions remain high in the Middle East, and 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

Feb. 18	German ZEW economic sentiment and U.S. Empire State Manufacturing Survey
Feb. 19	U.S. housing starts; UK inflation
Feb. 20	UK retail sales and euro area Consumer Confidence Indicator
Feb. 21	Flash composite PMI for the euro area, Japan and the U.S.; South Korea trade data for the first 20 days of February

This week's flash PMI data for a few key economies may show some temporary softening, especially in the manufacturing component. This would reverse the modest improvement prior to the coronavirus outbreak that we saw in January's data. South Korea's closely-watched trade data could offer a glimpse of the latest global trade dynamics.

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 remain modestly overweight on global equities. With central bank easing and expansion in valuation multiples largely behind us, we expect a growth uptick to take over as a key support. Valuations still look reasonable. An uptick in global manufacturing and trade activity favors a tactical tilt into more cyclical exposures, including EM and Japanese equities.

Credit

We maintain a modest overweight in global credit. The income potential of EM debt — particularly local-currency — looks especially attractive. With the growth uptick picking up the baton in supporting risk assets, we maintain our overweight view on global high yield after the asset class has cheapened. We see global investment grade debt as less attractive due to rich valuations.

Government bonds

We are overall neutral on global rates. Major central banks are likely to keep policy mostly on hold in the near term, even as growth and inflation firm somewhat. This tilts risks toward a steepening of the yield curve. We prefer shorter maturities in U.S. Treasuries. We like TIPS as we still see rising U.S. wage pressures and potential for supply shocks that could firm inflation beyond expectations.

Cash

We maintain our neutral position on cash for risk mitigation and are using some of it to support our view on government bonds. This is in line with our modest tilt to risk in portfolios. 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

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 maintain momentum as an underweight as valuations appear stretched. The factor has underperformed most other style factors in the second half of 2019.
Equities	Value			We keep value at neutral due to its pro-cyclical nature and prospects for renewed yield curve steepening.
Equities	Minimum volatility			We keep min-vol at neutral. The factor has historically performed well late in the cycle, but the growth uptick causes us to pull back. Valuations still appear expensive versus other factors.
Equities	Quality		■	We hold quality as an overweight. Valuations have modestly cheapened. The factor has been resilient in late-cycle periods and includes global firms that stand to benefit from improving trade activity.
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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