# Davos brief

January 2020

**The global economic expansion is stretching, but powerful structural trends are testing limits — and intersecting with the near-term outlook. The trends include rising inequality and social unrest; deglobalization and fragmentation into trade blocs; an intensifying focus on sustainability and the physical effects of climate change; and the limited toolkit that central banks have to fight the next downturn. The BlackRock Investment Institute, under the leadership of Jean Boivin, presents a sample of its insights in our Davos brief.**

**Philipp Hildebrand**
BlackRock Vice Chairman

**Tom Donilon**
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BlackRock **Investment** Institute

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**We see global economic growth edging up over the first half of 2020.** The unusual late-cycle, dovish pivot by central banks has led to a dramatic easing in financial conditions – one that we expect to start filtering through to the economy and result in an uptick in growth.

**U.S.-China trade tensions are likely to move sideways this year.** Yet we see no let-up in U.S.-China strategic competition, especially in the technology arena. Other geopolitical themes on our radar: global fragmentation and domestic polarization, social unrest, and rising risk of cyberattacks.

**We are modestly overweight risk assets on the firming growth outlook and pause in trade tensions.** Yields near lower bounds make government bonds less effective portfolio stabilizers, but we still see U.S. Treasuries providing resilience.

**The increasing focus on sustainability by a widening array of investors has set the stage for a significant reallocation of capital.** We believe assets perceived as most resilient to climate and other sustainability-related risks could outperform in the long transition period to a more sustainable world.

**This calls for building sustainable portfolios, improving access to sustainable investing and intensifying engagement with companies on sustainability.** Sustainability - the theme uniting leaders at the 2020 World Economic Forum in Davos, Switzerland – is the new investing standard.

**Dealing with the next downturn will require unprecedented coordination between monetary and fiscal policy.** Interest rates and long-term yields are nearing lower bounds in many economies. This means fiscal policy should play a greater role, but it is unlikely to be effective on its own.



2020 outlook — Medium-term outlook

**BlackRock**

# Economy

## Growth to pick up...

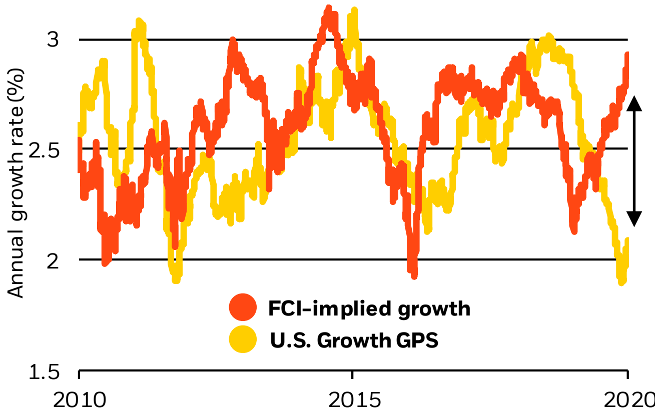
One macro puzzle that has cropped up over the past year: Why has the loosening of financial conditions not offset more of the growth slowdown? Has the transmission channel from financial conditions to growth broken down – and could expectations for a growth recovery in 2020 be misplaced? We don't think this is the case.

Elevated geopolitical and trade uncertainty has served as a drag on confidence and investment, while the weakness in global trade has also been surprisingly sharp. We believe this is one reason why our U.S. Growth GPS has underperformed relative to what we would expect based in its historical relationship with our financial conditions indicator (FCI).

See the gap highlighted by the arrow in the chart on the right. The elevated level of our BlackRock Geopolitical Risk indicator helps explain this gap, in our view, as well as why actual growth is so weak relative to what the FCI would signal. But we see this gap gradually closing this year amid a pause in trade tensions.

### A puzzling gap

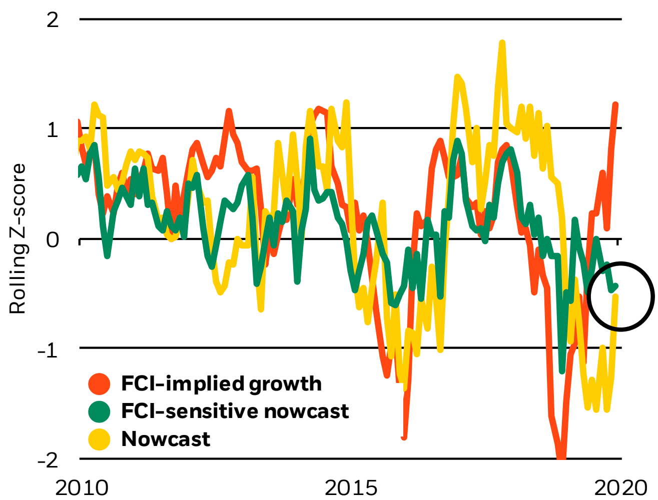
BlackRock U.S. Growth GPS and FCI, 2010-2020




Sources: BlackRock Investment Institute, with data from Bloomberg and Refinitiv Datastream, January 2020. Notes: The BlackRock U.S. Growth GPS shows where the 12-month forward consensus GDP forecast for the U.S. may stand in three months' time. The orange line shows the rate of U.S. GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass.

### The uncertainty drag

U.S. Growth GPS nowcast vs. FCI, 2010-2020




Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Haver Analytics, January 2020. Notes: The chart shows the rolling Z-scores of US Growth GPS, nowcast (actual economic data and excluding big data inputs), the nowcast components most sensitive to the FCI and the FCI. The FCI-sensitive nowcast is derived using regressions on the co-movement between the nowcast components and the FCI.

## ...as uncertainty dissipates

Global growth in 2019 was also buffeted by a series of one-off factors that hurt activity, such as automaker strikes in the U.S. and car emission rule changes in Europe. In addition, some sectors of the economy are not as sensitive to financial conditions as sectors such as housing.

When extracting the sectors from the nowcast component of our U.S. Growth GPS that are sensitive to financial conditions – the green line in the chart on the left – we don't see as much of a decline as signaled by the nowcast. And the nowcast has recently rebounded sharply to almost match the FCI-sensitive nowcast, suggesting that easing trade tensions and a bottoming out in global trade are helping growth inch up. This strengthens our view that trade policy uncertainty and a decline in global trade explain most of the slowdown relative to FCI-implied growth. And it is why we think a steadying of trade tensions can allow global growth to gradually pick up in 2020, as financial conditions stay supportive.

**"The U.S. consumer is currently in very good health. It's really what keeps the U.S. economy growing. You have a strong labor market with still a very robust pace of job growth and faster wage increases."**

**Elga Bartsch**
Head of Macro Research, BlackRock Investment Institute

# Geopolitics

## Three trends on our radar

Geopolitics — especially trade tensions — were key economic and market drivers in 2019. We see trade tensions moving sideways this year, giving the global economy room for a projected uptick in growth. Recent developments underscore this view and have been positive for markets — including the signing of an initial, albeit limited, trade agreement between the U.S. and China, the likely ratification of the U.S.-Mexico-Canada Agreement on trade, and a significantly reduced risk of a no-deal Brexit in the UK. Yet other geopolitical risks — such as further escalation between the U.S. and Iran — could undermine the growth uptick we expect and the returns of risk assets. The market's attention to geopolitical risks remains at elevated levels, as shown on the right.

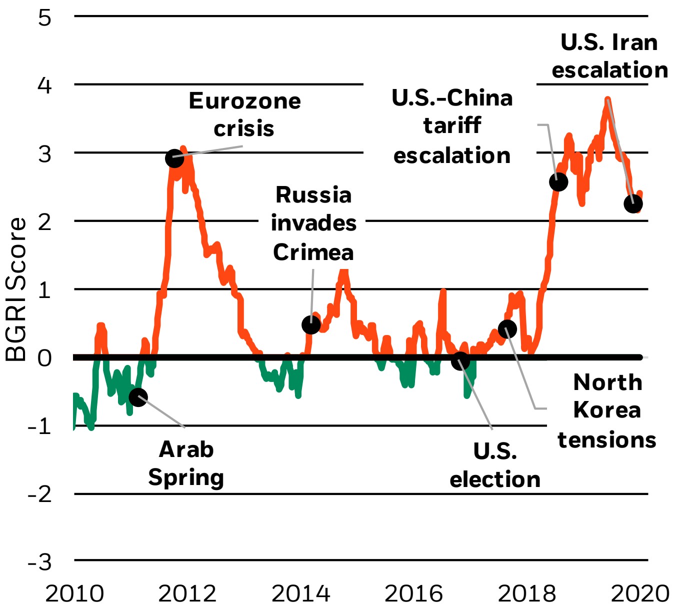
In the year ahead, we think investors should be alert to several broad dimensions of geopolitical risk. The first dimension is geopolitical fragmentation, cutting across trade, technology, ideology, and domestic politics. The decoupling of the U.S. and Chinese technology sectors will force countries and businesses to navigate a bifurcating landscape. Technology tensions and broader strategic competition between the U.S. and China will persist even after a limited "Phase 1" trade deal takes effect. In addition, political polarization is reaching a high point in many countries. We are most closely focused on what will be a highly contentious U.S. election, with the potential for starkly different policy outcomes. We have downgraded U.S. equities to neutral as a result.

Second, we see ongoing protest movements against establishments and institutions in 2020, fueled by rising income and wealth inequality, weak government performance, and environmental concerns in some cases. This social unrest has developed against a backdrop of economic expansion and strong asset returns. This begs the question: What happens in a downturn? Many governments are ill-equipped to respond, with limited monetary, fiscal, and political maneuvering room. The proliferation of social media has served to facilitate and exacerbate the unrest.

Lastly, we see rising cyber security risks in 2020. Tensions are elevated between the U.S. and many adversaries with the capability to mount attacks on the presidential election, such as Iran and North Korea. An uptick of "ransomware" attacks against cities and U.S. states with relatively poor defenses may be a sign of things to come. Markets look to be complacent: attention to cyberattacks, as reflected in analyst reports, financial and social media, has steadily declined since late 2017, our analysis shows. We see U.S. Treasuries including TIPS playing their traditional role as portfolio stabilizers in any stock market selloffs triggered by geopolitical risk in 2020.

### Politics on the mind

BlackRock Geopolitical Risk Indicator (BGRI), 2010-2020




Source: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: See BlackRock's Geopolitical risk dashboard for details. We identify specific words related to geopolitical risk in general and to our top-10 risks, and calculate the frequency of their appearance in Refinitiv Broker Report, Dow Jones Global Newswire databases and Twitter. We adjust for whether the language reflects positive or negative sentiment. A zero score represents the average five-year BGRI level. A score of one means the BGRI level is one standard deviation above average. We weigh recent readings more heavily in the average.

**"If you look at the list of geopolitical issues in the world, it's a very daunting list. But the important thing for investors to understand is that each of these has to be looked at individually – not all will go to worst case scenarios.**

**Tom Donilon**
BlackRock Investment Institute Chairman

# Markets

## BlackRock's 2020 investment themes

### Growth edges up

We see an inflection point in global economic growth as easier financial conditions start filtering through. The growth mix is shifting as the modest pickup is likely to be led by manufacturing, business spending and interest rate-sensitive sectors such as housing.

### Policy pause

We see economic fundamentals driving markets in 2020, with less risk from trade tensions and less scope for monetary easing surprises or fiscal stimulus. Major central banks appear intent on maintaining easy policies – and interest rates and bond yields look likely to linger near lows.

### Rethinking resilience

Yields are testing lower limits in developed markets, making many government bonds less effective portfolio ballast in equity market selloffs. We believe a focus on sustainability can help add resilience to portfolios as markets wake up to environmental, social and governance (ESG) risks.

Read our full *2020 Global outlook* for details.

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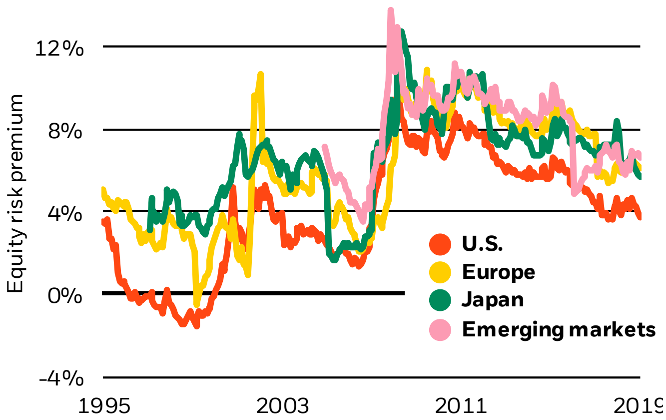
## A modest tilt into risk

We see less room in 2020 for dovish monetary policy surprises. The U.S. and China have strong incentives to hit pause on their trade conflict ahead of the U.S. presidential election, though there may be turbulence along the way. We see growth taking the reins as the primary driver of risk asset returns as a result. Our base case is for a mild growth pickup as easier financial conditions start filtering through and global trade activity ticks up amid a pause in tensions. We see this backdrop and reasonable valuations paving the way for modest return potential in global equities and credit.

We have moved to a moderately more cyclical posture, from a more defensive one we took in our midyear 2019 outlook. Our estimate of the equity risk premium (ERP) — or the expected return of equities over the risk-free rate — shows that the ERP still looks relatively attractive in a long-term context, as shown in the chart on the right. With income crucial in a slow-growth, low-rate world, we also favor EM and high yield debt.

**Reasonable valuations**

Equity risk premia, 1995-2019




**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, January 2020. Notes: Data are as of Sept. 30, 2019. We calculate the equity risk premium based on our expectations for nominal interest rates and the earnings yields for respective equity markets. We use MSCI indexes as the proxy for the markets shown. We use BlackRock expectations for interest rates so the estimate is not influenced by the term premium in long term bond yields.

> **"The bottom line for portfolios is that we think a modest tilt into risk assets like global stocks and credit will be rewarded in 2020."**
>
> **Mike Pyle**
> Global Chief Investment Strategist, BlackRock Investment Institute

# Sustainability

## A tectonic shift

Growing interest in sustainability and a shift in society's preferences are likely to spur political and regulatory changes. This could lead to a transformation in investor behavior – and a major, yet gradual, capital reallocation. Assets under management in dedicated environmental, social and governance (ESG) funds have tripled in the past decade to a little under US$1 trillion, according to IMF estimates as of June 2019.

Yet we see a far bigger structural shift afoot— akin to the multi-decade impact of the post-war "baby boom." This shift is unlikely captured in today's asset prices.

The physical risks associated with extreme weather events are fast becoming apparent. We believe these will amplify calls for regulatory action and accelerate the hunt for adaptive technologies — both triggers to spur capital reallocation. Major shocks related to sustainability — from hurricanes and wildfires in the U.S. and Australia, heat waves in Europe and flooding in various parts of the globe — will likely reinforce the preferences for sustainability among younger investors.

We believe this has significant consequences for the expected returns and relative pricing of assets across the investment universe. The wide-ranging implications of such a structural shift are currently underappreciated by markets, in our view. We believe structural demand for "sustainable" assets could cause them to outperform in this transition. The outperformance of sustainable assets may eventually dissipate. Yet we see a long runway for this transition to take place, given the relatively low penetration of sustainable investing strategies to date.

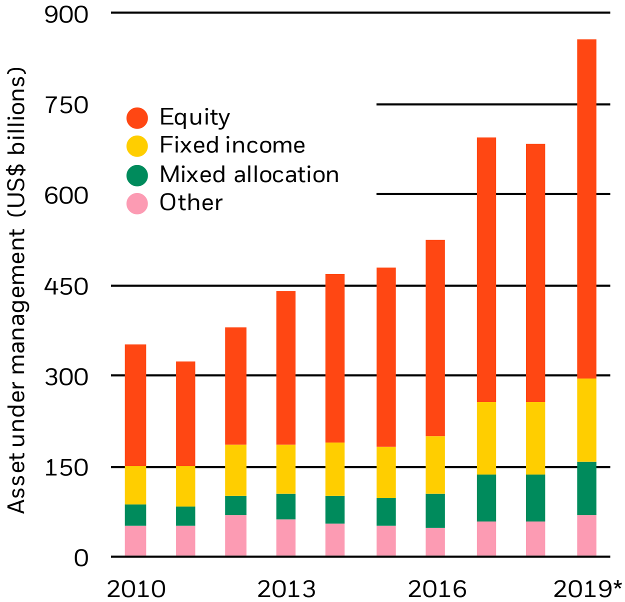
Against this backdrop, BlackRock is making an increased commitment to integrate sustainability across its technology platform, risk management and investment strategies. Among the many steps underway we are:

**Building sustainable portfolios:** Resilient and well-constructed portfolios are essential to achieving long-term investment goals. We believe sustainability must become a standard offering in investment solutions across the board. This includes reducing ESG risks by minimizing or eliminating exposure to certain sectors. One such example: Thermal coal is carbon intensive, becoming less and less economically viable, and highly exposed to regulation because of its environmental impacts. As a result, BlackRock's active portfolio managers are committed to removing all exposure to companies that derive more than 25% of revenues from thermal coal production.

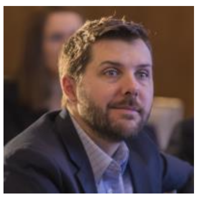
- **Improving access to sustainable investing**: Among other measures, BlackRock is working with index providers to encourage the development of sustainable versions of their flagship indexes.
- **Intensifying engagement**: BlackRock believes that collaboration between investors, companies and regulators is essential to improving the management of sustainability questions. We recently joined Climate Action 100+, a group of investors that engages with companies to improve climate disclosure and align business strategy with the goals of the Paris Agreement. BlackRock is also intensifying its investment stewardship efforts to engage with companies on sustainability-related risks. This includes voting on corporate sustainability proposals; BlackRock will be increasingly disposed to vote against management when it believes progress is insufficient.

### Gathering momentum

Growth in ESG funds under management, 2010-2019




Sources: BlackRock Investment Institute, with data from the IMF, January 2020. Notes: Data are based on IMF staff calculations using Bloomberg Finance data. The data for 2019 are as of June, the latest available set. The chart shows global ESG mandated funds only.



> **"We are in the early stages of a big reallocation in capital as the focus on sustainability intensifies."**

**Brian Deese**
Global Head of BlackRock Sustainable Investing

# Policy limits

## Coordination needed

Monetary policy is almost exhausted in many developed economies as global interest rates sit near zero or below. A central bank's entire tool kit is geared toward lowering short- or long-term interest rates to stimulate spending when needed. Yet this channel is almost tapped out because all rates are already low and are reaching limits. The chart on the right shows why, using today's German bund yield curve (yellow line) as an example. The red line is a hypothetical yield curve based on median curve moves during past recessions. Short-term rates would have to fall deep into negative territory – beyond estimates of the lower bound at which interest rates can be feasibly set. This implies there is not enough monetary policy space to deal with the next downturn.

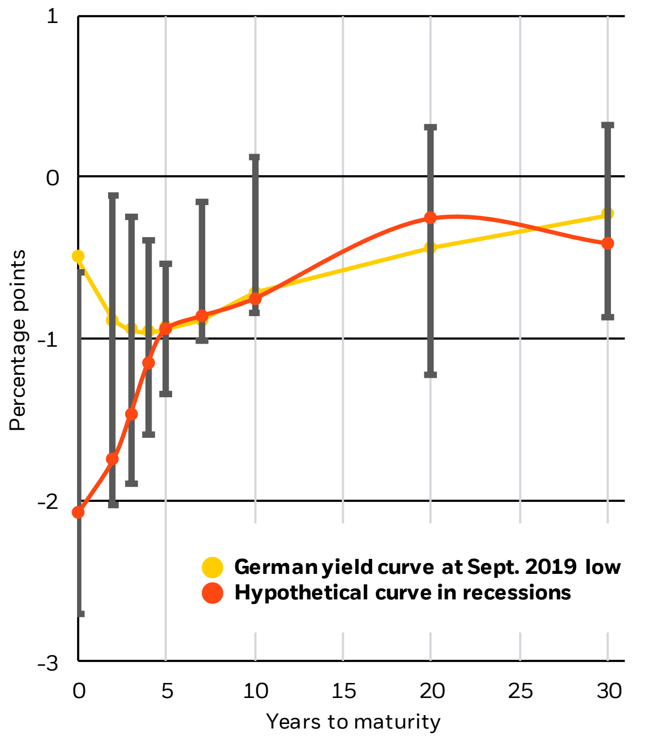
Other central banks face similar challenges: One-third of the developed market government bond and investment grade credit universe had negative yields as of early 2020, according to data from Refinitiv Datastream and J.P. Morgan. Global bond yields have closed in on their potential floor. This suggests monetary policy cannot provide much more stimulus through the interest rate channel – a liquidity trap situation.

Fiscal stimulus, which doesn't rely on lowering rates, is the obvious answer if monetary policy is tapped out. There is fiscal space as debt servicing costs are near record lows. There is a strong case globally for spending on infrastructure, education and renewable energy to boost potential growth. But despite this case, there has been an over-reliance on monetary policy. Fiscal policy is typically not nimble enough as it takes time to agree politically and implement. With global debt at record levels, major fiscal stimulus could also raise interest rates or stoke expectations of future fiscal consolidation, undercutting its stimulative boost.

As a result, policymakers will likely find themselves blurring the boundaries between fiscal and monetary policies to fight the next downturn. This threatens the hard-won credibility of policy institutions and could open the door to uncontrolled fiscal spending. Any successful policy response will need to bypass the interest channel and involve "going direct:" This means putting money more directly in the hands of entities that can spend it.

### Running out of ammunition

Hypothetical German yield curve in recessions, 2019




Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, August 2019. Notes: The chart shows the German bund yield curve on Sept. 3, 2019 when the 10-year yield hit a record low and a hypothetical yield curve. The hypothetical curve shows what the German bund yield curve would look like based on its median move during the past five recessions. The bars show the range of moves during those recessions. To account for the changing interest rate environment of the past few decades, the curve moves are adjusted based on the structural decline in neutral rates discussed on this page. Forward-looking estimates may not come to pass.

One way or the other, this involves a stronger form of coordination between monetary and fiscal policy. This raises important governance questions – and underscores the need to put guardrails around such policy coordination.

Our paper *Dealing with the next downturn* outlines the contours of a framework to enable an unprecedented coordination through a monetary-financed fiscal facility. This should mitigate the risk of a loss of central bank independence and uncontrolled fiscal spending in the next downturn.

**"In the next downturn, the boundaries between fiscal and monetary policies will likely blur. It's a slippery slope. This is why we need to put guardrails around policy coordination to prevent a loss of central bank independence or uncontrollable spending."**

**Jean Boivin**
Head of BlackRock Investment Institute

# Portfolio construction

## Role of government bonds

The dramatic drop in government bond yields in 2019, taking nearly a third of global bonds into negative-yielding territory at one point, has raised serious questions about their role in a strategic asset allocation (SAA). Low rates are not a new story. But the increasing proximity of government bond yields in certain regions to what we perceive as their prevailing lower bounds – particularly the euro area and Japan – materially reduces their attractiveness.

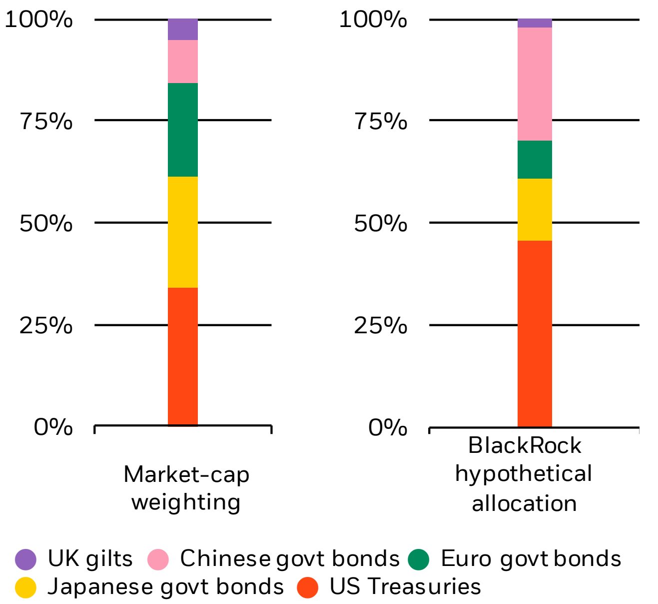
Investors had a glimpse of the risks associated with this in August, when yields plunged to lows. Bonds in the lowest-yielding regions, especially German bunds, were much less reactive than U.S. Treasuries to the shock to equity markets, with more muted price gains. This illustrates why we prefer higher-yielding U.S. Treasuries.

Reduced ballast is not the only challenge to the traditional role of government bonds. We believe that inflation is an under-appreciated risk. In a future regime where supply shocks rather than demand shocks dominate, average stock-bond correlations may turn positive, rather than negative, as has been the norm seen this millennium. All else equal, this argues for materially lower allocations to nominal government bonds as part of balanced multi-asset portfolios.

We believe a rethink of the starting point for government bond allocations is necessary in the current environment. China's vast government bond market offers a strategic opportunity, in our view. We see Chinese debt and equities warranting allocations above current weights in global indices. The chart on the right shows how our allocation to Chinese government bonds in a hypothetical, unconstrained U.S.-dollar portfolio compares to an allocation based purely on market-cap weights. The ultimate allocation will depend on an investor's objectives and constraints. Near-term risks to China's economy, particularly surrounding geopolitical and trade frictions with the US, have prompted a cautious stance among global investors – and some structural tensions may persist for years. Yet we see a strategic case for holding Chinese assets that goes beyond tactical considerations. We allow for a wide range of uncertainty in our return expectations to account for the multiple ways that China's economy and markets can evolve.

### A different starting point

Market-cap weighted allocation vs hypothetical portfolio




**Past performance is not a reliable indicator of current or future results. Reference to any asset class shall not constitute a recommendation to buy or sell.** Sources: BlackRock Investment Institute, November 2019. Notes: The charts show how our government bond allocations in a hypothetical unconstrained, US-dollar based portfolio on a 10-year horizon stack up against an allocation based purely on a market-cap weighting. The market-cap weighting is calculated on BlackRock's Aladdin as of November 6, 2019. The left chart shows only the fixed income part a market-cap weighted portfolio, scaled up to 100. The chart on the right shows the results after running our robust optimisation on our CMAs and incorporating our asset class views.

Our views on Chinese assets are not driven solely by the assumption that higher economic growth may result in higher expected returns. Instead they stem from the same fundamental considerations such as the outlook for interest rates, valuations and the path of returns we apply to other regions. See our capital market assumptions (CMAs) site for further details.

Incorporating uncertainty in our CMAs is a critical part of our portfolio construction process. We allow for a large amount of uncertainty in our long-run expected returns for Chinese equities given historically high volatility and the inherent challenges of estimating returns in rapidly evolving markets. Even so, the potential return and diversification benefits lead us to notable allocations.

**"Government bonds won't provide much ballast if yields are near lower bounds – this argues for a more selective approach to fixed income allocations.**

**Vivek Paul**
Senior Portfolio Strategist; BlackRock Investment Institute

# BlackRock Investment Institute

The BlackRock Investment Institute (BII) provides connectivity between BlackRock's portfolio managers; originates economic, markets and portfolio construction research; and publishes investment insights. Our goals are to help our portfolio managers become even better investors and to produce thought-provoking investment content for clients and policymakers.



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