Weekly commentary

Feb. 24, 2020

BlackRock

Our views on equity style factors

- We still favor the quality factor for its resilience in late-cycle periods, despite its muted performance this year.
- We retain for now our moderate pro-risk stance over the next 6-12 months, with an eye on rising uncertainties in the market outlook.
- Markets will watch this week's China official purchasing managers' index (PMI) data for evidence of the magnitude of activity disruptions.

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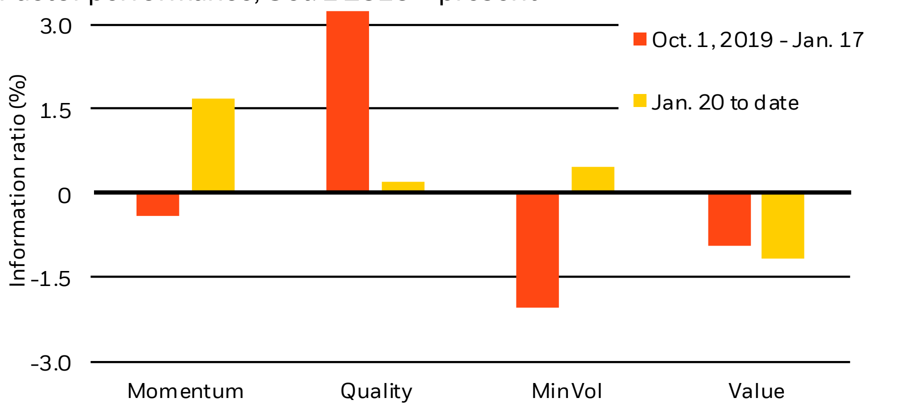
The coronavirus outbreak has altered market dynamics since late January. One example: Quality has posted more muted gains after strong outperformance in late 2019. We stand by our tactical views on factors for now, including a modest overweight on quality. These are anchored by our outlook that a global growth uptick will likely resume once the outbreak recedes, although the depth and width of the eventual V-shaped recovery are uncertain.

Chart of the week

Factor performance, Oct. 1 2019 – present



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 Bloomberg, February 2020. Notes: The bars show risk-adjusted returns of MSCI World Momentum, Quality, Minimum volatility and Value indexes from Oct.1, 2019 to just before Jan. 20 when China confirmed that the coronavirus could spread from person to person, and from Jan. 20 to date. We used the MSCI World Index as the benchmark as the benchmark in this analysis. The information ratio is calculated by subtracting a factor index's return for a given period from the total return of the benchmark, then dividing that result by the tracking error, or the standard deviation of the difference between individual index and benchmark returns.

The performance of equity style factors – broad, persistent drivers of return – has historically ebbed and flowed as the economy cycles through different regimes. The quality factor (companies with sound balance sheets) has tended to do well during late-cycle periods – such as where we stand now. Living up to this expectation, quality posted outsized returns in the fourth quarter in risk-adjusted terms, dominating other style factors. That outperformance has faded since the coronavirus outbreak – alongside improving performance of momentum (stocks with rising prices) and further weakness in value (cheap stocks relative to fundamentals). See the chart above. For now, we still see room for our factor views to play out over six to 12 months.

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What could explain the shifting dynamics behind factor returns since the coronavirus outbreak? We had expected quality to perform well over our tactical horizon of six to 12 months, as the factor has tended to be resilient in late-cycle periods and includes global firms that stand to benefit from a pause in trade tensions. The spread of the virus – and the containment measures imposed by the Chinese authorities – have triggered global supply chain disruptions and a hit to global growth, making such global firms vulnerable. We still see the outbreak delaying – but not derailing – the global growth uptick that we have been expecting to take root in 2020. As a result, we still favor quality on a tactical basis.

Momentum's outperformance in early 2020 has come as a surprise. We had expected a steepening of yield curves and overhang of growing regulatory risk in the tech sector to weigh on the factor - but coronavirus risks have caused investors to rotate back into these tried-and-true exposures. Momentum has a relatively high exposure to the information technology sector (21% of the MSCI World Momentum Index), which has been the leading global sector performer so far this year. Momentum is also populated with "bond proxies," or dividend-paying companies in healthcare and consumer staples. Today's historically low rates means that any small change in rates could have outsized repercussions for these stocks. Momentum has shown a meaningful negative correlation with the 10-year Treasury yield over the past year, our research shows. We see an eventual yield curve steepening and regulatory scrutiny around U.S. election as risks for the factor.

The negative correlation between momentum and value has strengthened in recent weeks. We maintain our neutral call on value as its pro-cyclical nature could benefit once the pickup in growth – and yield curve steepening - resume later this year as risks associated with the coronavirus ultimately recede. Declining global trade tensions, which also underpin our expectation for a stable dollar, are another potential support for value.

Risk assets have performed well since late 2019, thanks to a pause in trade tensions and improved global growth prospects. Yet uncertainties abound – from the impact of the coronavirus outbreak to the result of the U.S. election later this year. This reinforces our call for raising portfolio resilience. We maintain our moderate tactical overweight to quality, and are reviewing our overall risk orientation and tactical views in light of the coronavirus outbreak.

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.

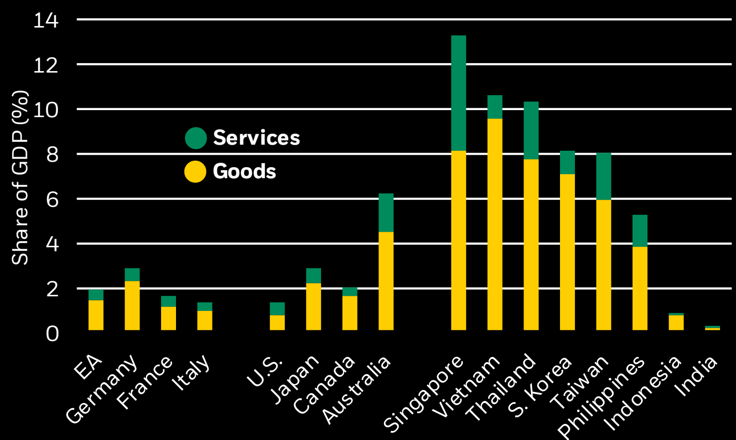
Macro insights

The euro area ended 2019 with GDP essentially stagnating. Sentiment data had started to improve in recent months. But this tentative recovery could stumble due to the coronavirus outbreak and the spillovers from efforts to contain the virus. The euro area is more exposed to Chinese export demand than the U.S. Yet the euro area also relies less on intermediate inputs from China in its domestic production than the U.S. or Japan, making it less susceptible to any supply chain disruptions.

At the same time, exports to China were already expected to take a hit even before the outbreak: the "phase one" deal between the U.S. and China will divert significant Chinese demand away from the euro area. Germany would be the hardest hit country. The European Central Bank would be challenged to respond to any material damage to the region's economy given that it has much less monetary policy ammunition compared with the Federal Reserve.

China the buyer

Gross exports to China as a share of local GDP



Sources: BlackRock Investment Institute and the Organisation for Economic Co-operation and Development, February 2020. Notes: The chart shows the goods and services that each country or area exports to China as a percentage of local GDP, using trade in added value data from the OECD, as of 2016.

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 due to the coronavirus outbreak. The macro impact thus far – within China and beyond – 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 to counter the sharp growth contraction from an increase in the country's sales tax, 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 has signaled a potential shift toward greater fiscal spending before the government's new budget in March.
- 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 weakening or breakdown of the negative correlation between returns of stocks and bonds could also undermine the portfolio ballast role of government bonds.
- 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.
- 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. 24	German ifo business climate and current conditions
Feb. 25	U.S. consumer confidence, Federal Reserve Bank of Richmond business survey
Feb. 27	U.S. durable goods
Feb. 29	China official manufacturing purchasing managers' index (PMI)

This week's China official PMI data will be in focus, as harsh measures to contain the coronavirus outbreak have raised concerns about their impact on economic activity. Our China Growth GPS, which shows where the consensus forecast on the Caixin composite PMI may stand in three months' time, has yet to pick up signs of activity disruptions. The high-frequency indicators of activity we track so far have indicated stabilization and very tentative signs of modest improvement.

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			
Credit			
Government bonds			
Cash			

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. Historically low yields, coupled with elevated valuations, leave the factor vulnerable to performance reversal in case of any interest rate snapback.
Equities	Value			We keep value at neutral due to its pro-cyclical nature and prospects for renewed yield curve steepening once the coronavirus outbreak recedes.
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 despite relatively high valuations. 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.

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