



## WEEKLY COMMENTARY • JULY 29, 2019

### Key points

- 1 We see government bonds retaining their crucial role as portfolio ballast, even after their yields have plunged.
- 2 The European Central Bank (ECB) kept interest rates unchanged, but explicitly opened the door to future easing.
- 3 The Federal Reserve is expected to cut interest rates at this week’s policy meeting as insurance against downside risks to the outlook.

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## 1 The importance of government bonds

Raising resilience is one of [our three investment themes](#) for the remainder of 2019 and beyond. The ability of a portfolio to withstand a variety of adverse conditions is crucial, particularly in a time of elevated macro uncertainty. Bonds’ role as ballast in portfolios is still meaningful even after bond yields have plunged, in our view.

### Chart of the week

Global stock vs. bond returns in years with negative stock returns, 2000-2019



**Past performance is not a reliable indicator of current or future results.** Sources: BlackRock Investment Institute, Thomson Reuters and Bloomberg, July 2019. Notes: The scatter plot compares the two-week return of U.S. Treasuries and U.S. equities, and that of German government bonds and European equities during stock market selloffs since 2000. Selloffs are defined as two-week periods during which equity markets fall by 7.5% or more. The indexes used are MSCI Europe Index, MSCI USA Index, Thomson Reuters Benchmark 10-year Government Bond Indexes for the U.S. and Germany. Returns are in local currency terms. Indexes are unmanaged. It is not possible to invest directly in an index.

The hope when holding government bonds in a multi-asset portfolio: Bond prices should rise when stocks fall, cushioning the overall portfolio impact of “risk-off” episodes. This has generally been the case since 1980, according to our study of U.S. and German government bonds. There have been exceptions. Take the “taper tantrum” of 2013: Then Fed Chairman Ben Bernanke hinted at reducing post-crisis monetary stimulus, sending both stocks and bonds lower. The negative correlation has held up especially in the post-crisis environment. We see government bonds providing important ballast against risk asset selloffs in the current environment, as trade and geopolitical frictions become a key market driver.



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## In search of ballast

The protection offered by global government bonds is still meaningful even as their yields have hit historical lows, in our view. Take German government bonds (or “bunds”), which have one of the lowest yields globally. The worry for investors: eurozone policy rates – already in negative territory – may be nearing an “effective lower bound (ELB),” or the minimum level of interest rates that central banks can feasibly set. This would suggest there is little further room for bund yields to fall – and their prices to rally – during equity market selloffs. The ELB is [tough to estimate](#) and its level can change over time. Some studies, including one from Princeton economist [Markus K. Brunnermeier](#), pin the euro area’s ELB around -1%. This (albeit highly uncertain) estimate would imply that euro area sovereigns still have some room for yields to decline, but they offer a thinner cushion than in the past against major equity shocks.

We see an important role for inflation-linked bonds, both as a ballast to equity selloffs driven by growth shocks and to underappreciated [inflation risks](#). Inflation-linked bonds generally rally when equity markets sell off, like nominal bonds. The potential unravelling of global supply chains over a longer horizon, as a consequence of protectionist policies, could lead to an unwelcome mix of sluggish growth and higher inflation – and a difficult environment for both equities and nominal bonds. A blend of nominal and inflation-linked bonds in strategic portfolios can create resilience to a variety of adverse conditions. In addition, low inflation expectations have made inflation-linked bonds inexpensive, adding to their appeal.

We stress the importance of government bonds in building portfolio resilience, yet there are tactical considerations to take into account. We see potentially better entry points for U.S. Treasuries in the next few months relative to bunds, especially if the Fed’s policy meeting this week – or in coming months – moderates some of the excessive market expectations for easing measures. Tactically we favor European sovereigns with a preference for peripherals, given our view that the ECB is likely to meet – or even exceed – market expectations for further easing.

## 2 Week in review

- The ECB kept interest rates unchanged, but signalled its intention to introduce a comprehensive easing package in upcoming meetings, including rate cuts and possibly restarting asset purchases. The head of the People’s Bank of China said China’s interest rates were at appropriate levels, hitting back against speculation of rate cuts.
- Global stocks edged up last week, with mixed earnings reports in the second week of second-quarter corporate earnings reporting season.
- Manufacturing activity data fell below expectations in the eurozone. The manufacturing purchasing managers’ index (PMI) dropped to the lowest levels in about seven years in both Germany and the eurozone. The U.S. manufacturing PMI also slumped, to nearly a decade-low.

## Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	1.7%	22.1%	8.8%	1.9%
<b>U.S. Small Caps</b>	2.0%	18.0%	-5.5%	1.7%
<b>Non-U.S. World</b>	-0.4%	13.7%	-0.7%	3.2%
<b>Non-U.S. Developed</b>	-0.2%	14.1%	-1.0%	3.4%
<b>Japan</b>	-0.3%	8.5%	-5.1%	2.5%
<b>Emerging</b>	-0.8%	10.7%	-0.9%	2.8%
<b>Asia ex-Japan</b>	-0.7%	10.7%	-1.6%	2.5%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	1.6%	18.0%	-14.9%	\$ 63.46
<b>Gold</b>	-0.5%	10.6%	16.0%	\$ 1,419
<b>Copper</b>	-1.7%	0.0%	-5.2%	\$ 5,963

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	-0.2%	4.8%	7.4%	2.1%
<b>U.S. TIPS</b>	-0.3%	6.2%	5.6%	2.2%
<b>U.S. Investment Grade</b>	0.2%	10.1%	10.4%	3.2%
<b>U.S. High Yield</b>	0.5%	10.5%	7.1%	5.8%
<b>U.S. Municipals</b>	0.2%	5.8%	7.2%	1.9%
<b>Non-U.S. Developed</b>	-0.6%	4.0%	3.4%	0.5%
<b>EM \$ Bonds</b>	0.5%	12.7%	10.9%	5.4%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	-0.8%	-3.0%	-4.4%	1.11
<b>USD/Yen</b>	0.9%	-0.8%	-2.3%	108.68
<b>Pound/USD</b>	-1.0%	-3.0%	-5.5%	1.24

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Refinitiv Datastream. As of July 26, 2019. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg Barclays Global Aggregate ex USD; and emerging market \$ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound.

# 3 Week ahead

## July 30

U.S. personal income and outlays; Bank of Japan (BoJ) rates decision

## Aug 1

China Caixin manufacturing PMI; Bank of England rates decision; U.S. ISM manufacturing PMI

## July 31

Fed rates decision; China official manufacturing PMI; eurozone second-quarter gross domestic product (GDP)

## Aug 2

U.S. nonfarm payrolls

The Federal Reserve is poised to cut interest rates this week as insurance against significant downside risks to the outlook. The market expects the central bank to cut rates by 25 basis points at the meeting, with the possibility for even more. In total, the market is pricing in one percentage point of rate cuts in total through the end of 2020. We view this as excessive given that the near-term risks of recession appear limited. The possibility of a snapback in yields explains our cautious tactical view on U.S. Treasuries.

## Asset class views

Views from a U.S. dollar perspective over a three-month horizon

	Asset class	View	Comments
Equities	U.S.	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective, we like momentum and min-vol, but have turned neutral on quality due to elevated valuations.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	U.S. government bonds	▼	We have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply-demand dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver –or even exceed –stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We have upgraded EM bonds to overweight on their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities in Latin America and in countries not directly exposed to U.S.-China trade tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing. We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

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