Weekly commentary

Jan. 20, 2020

BlackRock

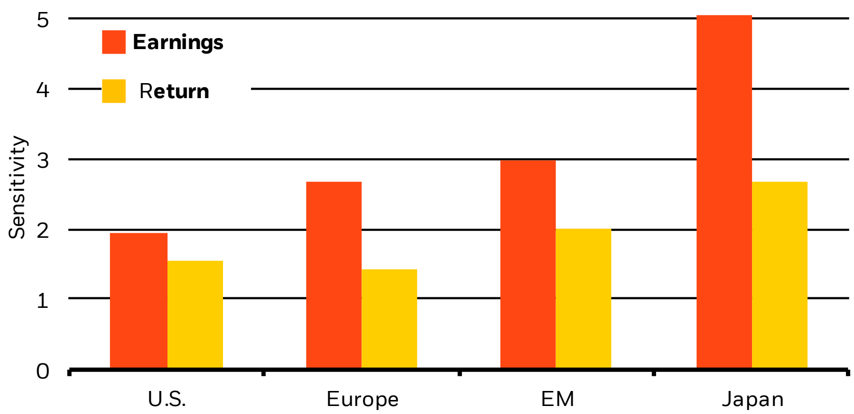
A cyclical rotation

- We favor a cautious tilt into cyclical assets, with expectations for a rebound in global trade and manufacturing activity.
- We see global growth stabilizing and gradually picking up over the next six to 12 months, thanks in part to easy financial conditions.
- This week's Davos forum will likely shine a light on big structural themes such as the intensifying focus on sustainability.

Markets have greeted the new year with optimism. The signing of a limited "Phase 1" deal between the U.S. and China reinforces our expectation for global trade tensions to take a pause in 2020. Generally positive economic data and an encouraging start to the latest quarterly earnings season also back our call for a potential bounce in risk assets. In equities, we are overweight emerging market (EM) and Japanese equities, and have upgraded the value style factor to neutral.

Chart of the week

Earnings and return sensitivity to global industrial output, 2000-2019



Sources: BlackRock Investment Institute, with data from Refinitiv, MSCI, the Netherlands Bureau for Economic Policy Analysis, and the National Bureau of Economic Research, January 2020. Notes: Each region's equity market is represented by the respective MSCI index. Sensitivity to global industrial production is calculated by comparing the changes in 12-month forward earnings estimates and equity market total return to the changes in global industrial production on a rolling three-month basis. We used the world industrial production data from the Netherlands Bureau for Economic Policy Analysis and forward earnings based on I/B/E/S estimates in this study, from the start of 2000 to October 2019 excluding recessions.

Cyclical assets have severely underperformed in recent years, including amid a global growth slowdown. We believe a rebound in global trade and capex should pave the way for stronger performance of cyclical assets over a six-to-12 month horizon, even as we see some long-term trends weighing on these assets, such as the structural downshift in China's growth. We studied the sensitivity of corporate earnings and equity returns to fluctuations in global manufacturing activity over the past two decades in different regions. See the chart above. The conclusion? Earnings estimates – as well as equity returns – in EM and Japan have historically been the most sensitive. This suggests these equity markets may have room for outperformance during a global growth pickup.

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BlackRock **Investment** Institute

Recent data support our expectation for a pickup in growth this year. World trade volumes appear to have stabilized after sharp declines since 2018. China has reported better-than-expected trade data – alongside rebounding industrial profits and improving manufacturing activity. Financial conditions have eased significantly in developed economies since early 2019, and look poised to filter through to support the real economy in the next six to 12 months. Our BlackRock GPS, which gauges where consensus gross domestic product (GDP) forecasts may stand in three months' time, indicates global growth should be accelerating slightly through the year. We see this environment as positive for cyclical EM assets.

Japanese equities may benefit from the same dynamics – as well as a pause in U.S.-China trade tensions – due to the export-oriented nature of the Japanese economy. A few other factors work in its favor. A weakened Japanese yen – currently at the lowest level against the dollar since mid-2019 – has historically tended to help lift Japanese stocks. We expect the Bank of Japan to stand pat on its ultra-loose monetary policy and the government to launch sizable fiscal stimulus this year, providing further support for the market. An ongoing improvement in corporate governance is another positive. Share buybacks have surged – up 40% in 2019 to a record high of 7 trillion yen (about $64 billion), according to Morgan Stanley. This should help boost return on equity and share performance. Yet most foreign investors are still underweight the market.

We have also upgraded the value style factor to neutral on a tactical basis amid expectations for a modest cyclical upswing in this late-cycle period. We expect a firming in industrial and trade activity – as well as a steepening yield curve – to underpin the factor. The underperformance in recent years – with the drawdown in value now the third worst and the longest in almost 100 years based on the Fama-French data set – also supports our tactical call. Among other factors, we are moderately overweight quality, which includes many global firms that stand to benefit from easing trade tensions.

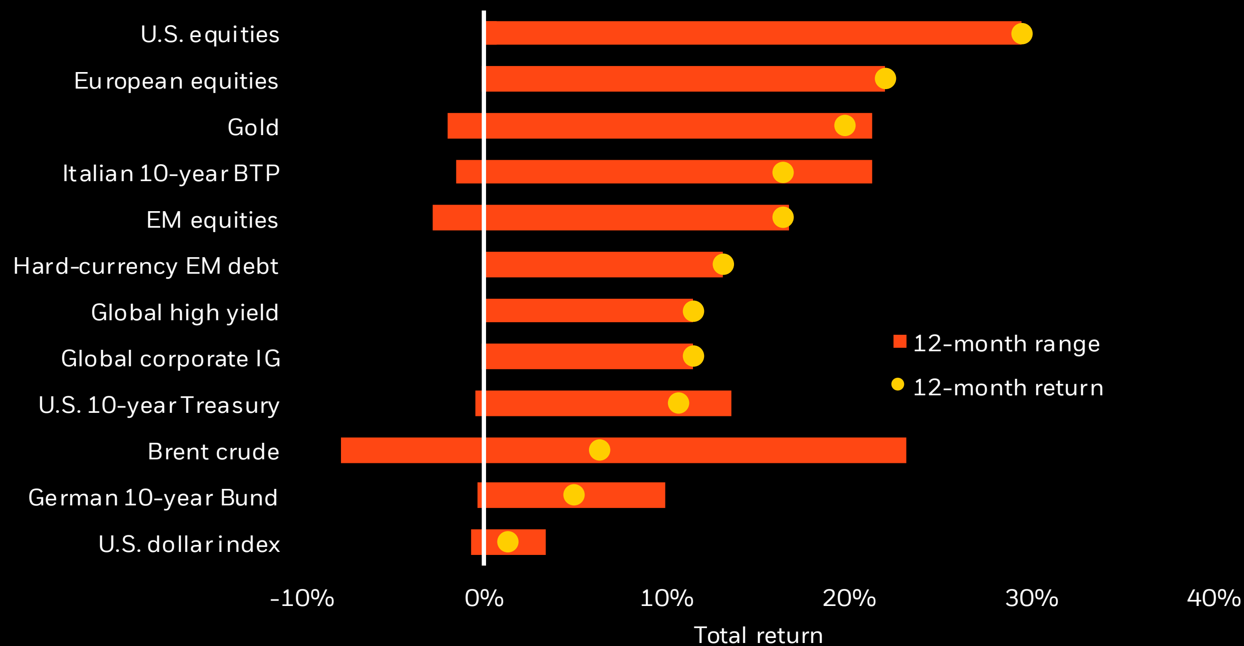
Bottom line: We favor a cautious tilt into cyclical assets, including Japanese and EM equities. In bonds, we prefer EM and high yield debt. The risks to our view include profit margin erosion and an unexpected slowdown. For now we expect revenue growth to boost corporate earnings even as profit margins decline, but higher costs – from wage increases or supply chain disruptions - may eat into profits.

Market backdrop

An escalation in Middle East tensions has spurred a cautious start to the year for risky assets. Abating trade tensions, signs of economic stabilization in China and still accommodative financial conditions have spurred a rebound. We are on the watch for more signs that global manufacturing may be bottoming out. We see the dovish pivot by major central banks as having run its course for now. We expect growth to stabilize and gradually pick up over the next six to 12 months as easier financial conditions start filtering through and sideways protectionist pressures give global trade activity some breathing room. See our macro data dashboard.

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, January 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.

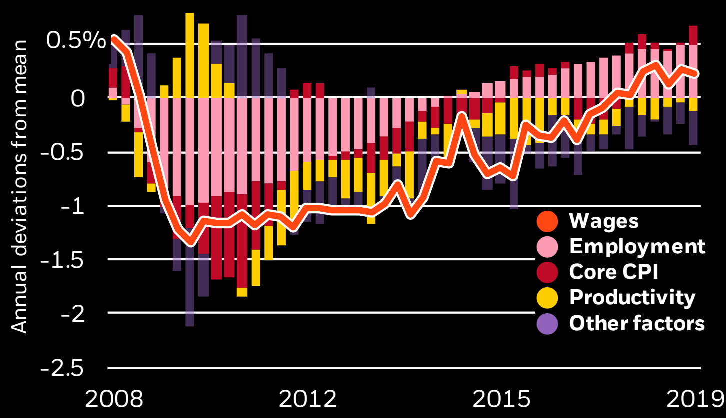
Macro insights

Signs of more tepid wage growth in Friday's U.S. labor market report do not change our outlook for firming wage inflation and some more pressure on profit margins. Why? Unusually strong employment demand for a late-cycle environment is likely to provide ongoing support to wage and consumption growth.

Markets are still under-pricing inflation risks, in our view. U.S. wage growth is sufficiently high to offset the rise in core consumer prices, boosting real wage increases. When translating recent U.S. core consumer price increases into the core personal consumption expenditures (PCE) index - the Fed's target - US inflation is currently running close to the 2% target. A possible mild inflation overshoot is unlikely to affect the Fed's policy stance given its focus on offsetting past undershoots – and as long as inflation expectations stay contained.

Wages on the rise

U.S. wage drivers, 2008-2019



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream, January 2020. Notes: This chart shows the annual change in the Employee Cost Index and the annual change of various implied components relative to their respective means from 1996-2019. The decomposition is similar to that done by former Fed Chair Janet Yellen in a September 2015 speech.

Investment themes

1 Growth edges up

- We see global economic growth edging higher 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.
- We believe the U.S. and China have strong incentives to hit pause on their trade conflict across 2020, though there may be turbulence along the way. A limited "Phase 1" trade deal between the U.S. and China as well as a revised North American trade pact should allow global trading activity some breathing space.
- We see China's economy stabilizing but little appetite among its leadership for large-scale stimulus. Europe and emerging markets should see higher average growth rates as they recover from a weak 2019.
- **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 policy easing should start to filter through to economic activity.
- The Federal Reserve has reaffirmed that the bar for further policy easing is high — with no policy action barring a significant growth slowdown or an unwanted tightening in financial conditions.
- 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 Europe and Japan, as well as EM ex-China. We see the U.S. presidential election overshadowing the U.S. fiscal policy debate in 2020.
- The bottom line: We see little chance of meaningful fiscal stimulus, but believe even 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

- The dovish pivot in 2019 pushed bond yields in some developed markets near levels we consider to be their lower bounds. This implies less room for yields to fall during risk asset selloffs.
- A weakening or breakdown of the negative correlation between stocks and bonds could also undermine the portfolio ballast role of government bonds.
- A focus on sustainability can also help make portfolios more resilient, in our view, by reducing exposure to environmental, social and governance (ESG) risks.
- The U.S. killing of a top Iranian military leader in the Middle East marked an escalation in the U.S.-Iran conflict. The U.S. and Iran have stepped back from direct military confrontation. Attacks on energy infrastructure in the region or disruption in shipping would generate greater market impact, in our view. Generally, we believe markets are underestimating cyber risks. See our geopolitical risk dashboard.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and like inflation-protected securities against inflation risks.

Weeks ahead

Jan. 21-24 Davos World Economic Forum

Jan. 23 Japan trade data for December 2019

Jan. 24 Japan December consumer price index; Japan, euro area, UK and U.S. composite Purchasing Managers' Index

Global business and political leaders gather this week for the annual Davos meeting. Discussions will likely feature powerful structural trends that are testing limits – and intersecting with the near-term outlook. These include rising inequality and social unrest; deglobalization and fragmentation; an intensifying focus on sustainability (as reflected in BlackRock CEO Larry Fink's annual letter); and the limited toolkit that central banks have to fight the next downturn. Read our Davos brief.

Directional views

Tactical views on major global assets from a U.S. dollar perspective, December 2019

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 also upgrade our 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 as well as exposures to inflation-linked debt amid 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

Tactical views on selected assets vs. broad global asset classes by level of conviction, December 2019

Change in view: Previous → New

	Asset	Underweight	Overweight	
Equities	United States			We have downgraded U.S. equities to neutral. Rising uncertainty around the 2020 election and a wide range of potential policy outcomes may weigh on sentiment and prevent a repeat of outperformance.
Equities	Euro area			We have downgraded European equities to 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 have upgraded 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 have upgraded EM equities as beneficiaries from the global recovery. EM central banks outside of China are likely to stay on their easing paths, supporting growth and equity markets.
Equities	Asia ex-Japan			We have upgraded Asia ex-Japan equities to neutral amid prospects of a growth uptick. We see China's economy stabilizing but stimulus as capped. Disruptions in global trade pose downside risks.
Equities	Momentum			We have downgraded momentum to underweight as valuations appear stretched. The factor has underperformed most other style factors in the second half of 2019.
Equities	Value			We have upgraded value due to its pro-cyclical nature and a steepening yield curve. We see an attractive entry point after value has substantially underperformed other factors in recent years.
Equities	Minimum volatility			We have downgraded min-vol to 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 have upgraded quality. 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 have upgraded U.S. Treasuries, 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			We like TIPS due to cheap valuations relative to current inflation levels – and potential for more price pressures due to wage pressures, an uptick in activity and longer-term deglobalization.
Fixed Income	German bunds			We have downgraded German government bonds. Prices already reflect the ECB's easy policy stance. And we see limited scope for monetary easing to take rates to even more negative levels.
Fixed Income	Euro area peripherals			We have downgraded 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 have downgraded global investment grade credit. 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 have upgraded global high yield, supported by stable monetary policy and the prospect of a growth inflection. Spread widening, especially in lower-rated cohorts, has offered an entry point.
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 have upgraded local-currency EM debt to 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 have upgraded Asia fixed income. 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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