Weekly commentary

BlackRock

Dec. 16, 2019

Our top investment calls for 2020

- We have made meaningful changes to our tactical asset views heading into 2020, including a moderate tilt into cyclical assets.
- We see growth stabilizing and gradually picking up over the next six to 12 months, thanks in part to easy financial conditions.
- The Bank of England is likely to keep policy rates on hold in its first policy decision since the UK Conservative Party's large election win.

Two dueling forces have shaped asset performance in 2019: the protectionist push and a dovish pivot in monetary policy. The latter won out for risk assets, fueling multiple expansion in equities and helping send bond yields to historic lows. What do we expect in 2020? The three new themes we introduce in our 2020 Global outlook point to a big change in market drivers, with an expected manufacturing-led growth uptick painting a better backdrop for cyclical assets.

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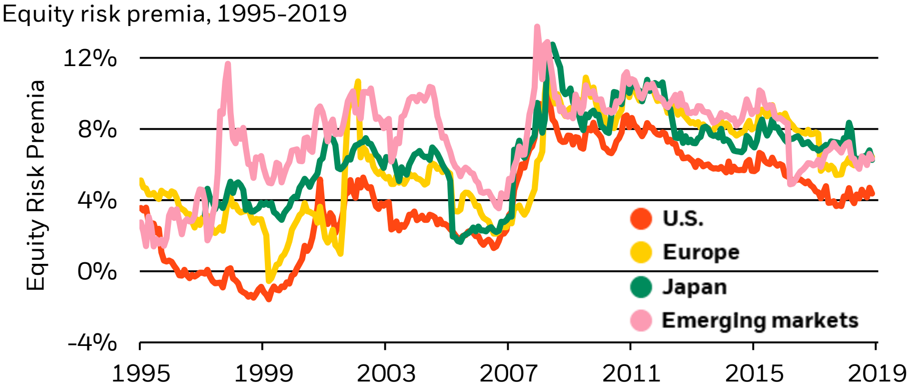
Chart of the week

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, December 2019. Notes: Data is 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.

This year's major market drivers appear to be behind us. We see less room in 2020 for dovish monetary policy surprises, and 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. We see growth now taking the reins as the driver of risk asset returns. Our base case is for a mild growth pickup as easier financial conditions start filtering through and sideways protectionist pressures give global trade activity some breathing room (our "growth edges up" theme). We see this backdrop — coupled with what appear to be reasonable valuations across equities and credit — paving the way for modest returns in global risk assets. 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 evident in the chart above. This supports our modest tilt into risk for 2020.

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BlackRock **Investment** Institute

We have moved to a moderately more cyclical posture, from the more defensive one we took in our midyear 2019 outlook. Cyclical assets have severely underperformed in recent years. We believe a firming in global trade and capex should pave the way for stronger performance of cyclical assets, such as Japanese stocks, emerging market (EM) assets and high yield bonds, over a 6-12 month tactical horizon.

Japanese and EM equities are among those set to benefit most from a global manufacturing recovery and a lull in U.S.-China trade tensions, in our view. And EM central banks outside of China are likely to stay on their easing paths, supporting growth and equity markets. From a factor perspective, we have upgraded quality because companies in that basket tend to be more resilient to late-cycle risks and should benefit from a pause in trade tensions. We see U.S. stocks performing more in line with global equities in 2020 after their long stretch of outperformance, as rising political uncertainty in a presidential election year may weigh on sentiment.

Changes to our fixed income views come amid less scope for monetary easing surprises or fiscal stimulus (our "policy pause" theme). Major central banks appear intent on maintaining easy policies – and interest rates and bond yields look likely to linger near lows. With income crucial in a slow-growth, low-rate world, we favor EM and high yield debt. We have downgraded global investment grade credit, as low coupon rates make the sector's income relatively unattractive on a risk-adjusted basis. At the same time, yields testing lower limits in developed markets and underappreciated inflation risks call for a rethink of the role of bonds as portfolio ballast (our "rethinking resilience" theme). We favor shorter maturity U.S. Treasuries to lower-yielding developed market peers and also like inflation-protected securities. Both can also potentially provide cushion against risks to growth, such as a breakdown in U.S.-China trade talks. Finally, we believe a focus on sustainability can help add resilience to portfolios as markets wake up to environmental, social and governance (ESG) risks.

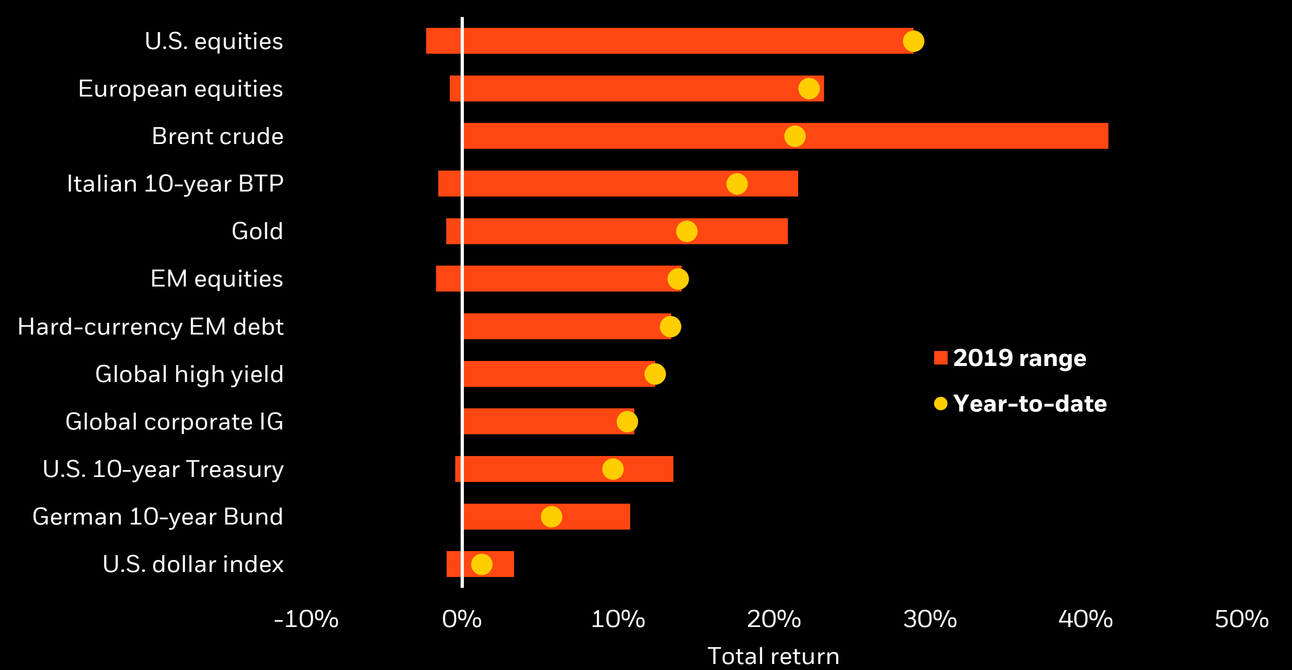
Read more on our updated asset class views in the table below and in our 2020 Global outlook. The *Weekly commentary* will resume on Jan. 6, 2020. Happy Holidays.

Market backdrop

A perceived lull in geopolitical frictions has boosted risk assets. 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, 2019 year-to-date and range



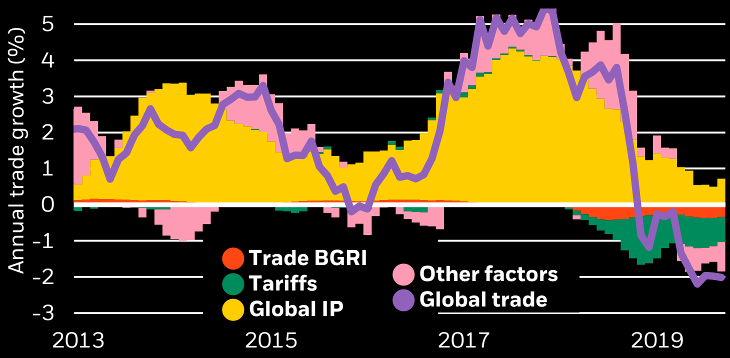
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2018, and the dots represent year-to-date returns. 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

Global trade volumes fell noticeably in 2019. We see the impact of trade policy uncertainty subsiding, but other persistent factors may remain a drag. Our global trade BGRI – a measure of market attention to trade risks – declined from the highs reached earlier this year as the U.S. and China agreed on their "Phase 1" trade deal. We estimate that the direct effect of trade policy uncertainty and trade tariffs have lowered trade growth by about 2 percentage points. Additional drags came from indirect effects – notably the sharp slowing in global industrial production. We expect global growth to edge higher next year, supported by looser financial conditions. But a global trade recovery depends on trade tensions leveling off and not escalating further. We believe the incentives for the U.S. and China to further hit pause on their trade conflict are strong in 2020, although there could be turbulence along the way. A breakdown of talks could revive protectionist pressures.

Trade troubles

Drivers of global trade growth, 2013-2019



Sources: BlackRock Investment Institute, CPB, U.S. Census Bureau and U.S. Treasury, with data from Refinitiv, Dec. 2019. Notes: The chart shows the influence of selected economic drivers on global trade growth. Industrial production is global Industrial production minus construction; tariffs are calculated as U.S. Treasury custom duties over imports of goods and services from the Census Bureau; BGRI is our trade uncertainty indicator. Other factors that have an explanation of trade by using a regression-based decomposition of trade drivers: U.S. GDP growth, U.S. industrial production, and the broad trade weighted dollar.

Investment themes

1 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.
- 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 "Phase 1" limited trade deal in principle 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.
- The UK Conservative Party's large election win gives Prime Minister Boris Johnson a mandate to deliver Brexit in January, but a difficult end-2020 deadline looms to negotiate a trade deal with the EU. We expect an extension. **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 reaffirmed last week 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 passing of the baton from monetary to fiscal stimulus. We believe policymakers should lay the groundwork for a credible plan to navigate the next economic shock that includes unprecedented coordination between monetary and fiscal measures. We lay out the contours of such a framework in *Dealing with the next downturn*.
- 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

- This year's sharp shift on monetary policy and interest rate expectations has pushed some bond yields near levels we consider as their lower bound, implying less room 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.
- **Market implication:** We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and like inflation-protected securities against inflation risks.

Weeks ahead

Dec. 17–18	Japan balance of trade; U.S. industrial production and housing starts; German Ifo business climate	**Dec. 31**	U.S. consumer confidence
Dec. 19	Bank of England rate decision; Bank of Japan rate decision	**Jan. 3**	German inflation

Markets will pay close attention to the first Bank of England (BoE) policy rate decision since the December 12 UK election, which gave Prime Minister Boris Johnson the mandate to push ahead with Brexit. The BOE is likely to keep policy rates on hold, with the government due to nominate a successor to BOE Governor Mark Carney early in 2020.

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

Underweight | Overweight

Change in view: Previous → New

	Asset	
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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