Weekly commentary

BlackRock.

Jan. 6, 2020

Why we like inflation-linked bonds

- We see Treasury Inflation-Protected Securities (TIPS) playing a key role as portfolio ballast against both growth shocks and inflation risks.
- We see global growth stabilizing and gradually picking up over the next six to 12 months, thanks in part to easy financial conditions.
- Markets will focus on the U.S. nonfarm payrolls data for December with the expectation for a still robust labor market.

We see inflation risks as underappreciated in 2020 – and beyond. Our base case is for modestly higher U.S. inflation this year, with a risk of upside surprises. Drivers include rising wages and energy price volatility in the short term, and deglobalization over time. We like TIPS on a tactical basis as their valuations look attractive relative to our outlook. TIPS can also serve as a source of portfolio resilience on a strategic basis, against both inflation and growth shocks.

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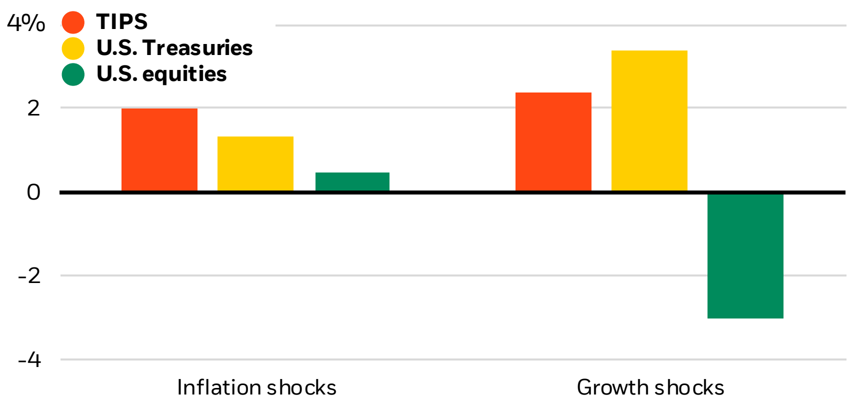
Chart of the week

Average asset returns under inflation and growth shocks, 1997-2019



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, MSCI, Citigroup, with data from Refinitiv Datastream, December 2019. Notes: The chart shows quarterly returns for U.S. government bonds (Bloomberg Barclays U.S. Treasury Total Return), TIPS (Bloomberg Barclays U.S. Treasury inflation notes total return index) and equities (MSCI USA Total Return index) in U.S. dollar terms during upside inflation shocks and downside growth shocks. The periods for inflation and growth shocks are measured as those quarters during which Citi's inflation and growth surprise indexes recorded a greater than 1 standard deviation relative to their history. Indexes are unmanaged and not subject to fees.

Government bonds play an important role cushioning multi-asset portfolios against equity selloffs. Our analysis showed both nominal U.S. Treasuries and their inflation-linked peers have generated positive returns when growth shocks triggered equity selloffs – albeit with nominal bonds beating TIPS. Why? Declines in both expected inflation and real rates help drive up nominal bond returns, while TIPS only benefit from falling real rates under such a scenario. TIPS' relatively limited liquidity may also mute their rally during any market stress. But TIPS have outperformed in inflation shocks. See the chart above. The "double resilience" property of TIPS – their ability to cushion against adverse growth *and* inflation surprises – is why we see a case for substituting some nominal government bond exposures for TIPS in strategic allocations.

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The dovish pivot by key central banks in 2019 and easing of financial conditions have played an important role in setting up global growth for a modest pickup this year – our base case for 2020. We already see inflation firming on the back of rising capacity utilization and stronger wage growth. The potential for upside inflation surprises in the U.S. has led us to favor TIPS on a 6-12 month tactical horizon. Our BlackRock Inflation GPS points to core (excluding food and energy) consumer price inflation rising to around 2.4% in six months' time, slightly above consensus expectations and the November reading of 2.3%. Yet market-based inflation expectations remain depressed. The pricing of 10-year TIPS implies an expected average annual inflation rate of just 1.8% over the next decade – a persistent undershoot of the Federal Reserve's inflation target. Meanwhile the U.S. labor market boasts the lowest unemployment level in nearly half a century and wage gains are near their strongest in a decade. We believe the Fed will likely allow temporary inflation overshoots and see a high bar for it to raise rates. This all points to upside risks to inflation – and an attractive entry point for TIPS given depressed market prices.

Over time we also see the risk of a regime shift that raises inflationary pressures while dragging on growth. Supply shocks stemming from structural trends such as deglobalization are one potential trigger. Geopolitical and trade frictions could disrupt global supply chains. This would reduce productivity and reinforce a slowdown in potential growth, while pushing up input costs. When such supply shocks dominate, stock and bond prices often have moved in the same direction, our analysis of the U.S. business cycle since 1965 shows. This would be a big shift from the environment since the late 1990s, when the negative correlation between stock and bond returns has made bonds effective portfolio diversifiers. TIPS could provide some portfolio resilience under such a scenario. The market price dynamics described earlier make it a good time to start building a strategic TIPS position, in our view, even as we expect trade tensions likely to move sideways in 2020.

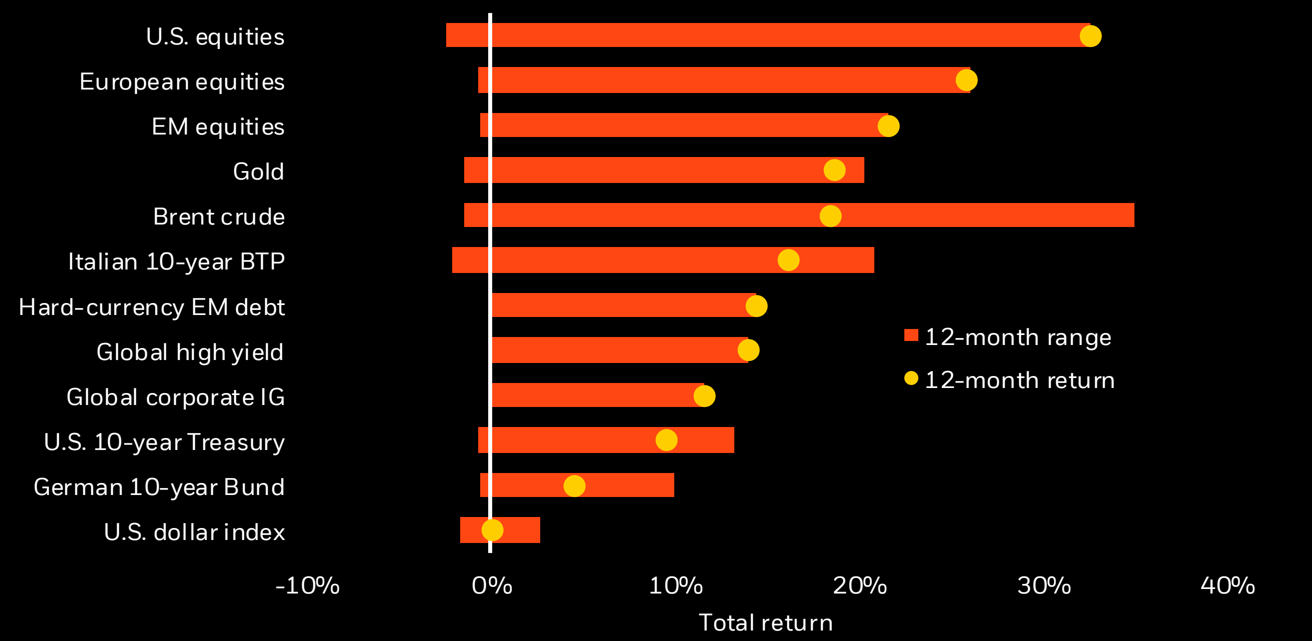
Bottom line: We like TIPS on a tactical basis, and would avoid inflation-linked bonds in the euro area or Japan as inflation expectations still appear depressed but actual inflation rates are stubbornly below central banks' targets. On a strategic basis a blend of nominal and inflation-linked U.S. government bonds could create resilience to a variety of adverse conditions, including both growth and inflation shocks. We also tilt toward U.S. Treasuries for portfolio ballast, as European and Japanese government bond yields appear to near lower bounds, diminishing their ability to cushion portfolios.

Market backdrop

A perceived lull in U.S.-China trade 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 in the past 12 months



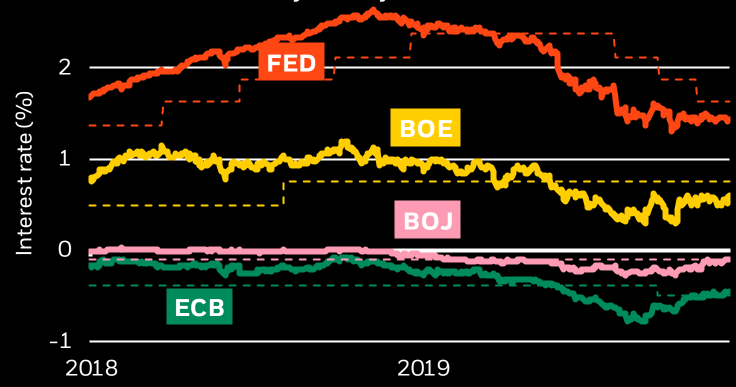
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2020. Notes: The two ends of the bars show the lowest and highest returns over the last 12 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

The Fed and the European Central Bank (ECB) have said that they are taking a policy pause in 2020, underscoring our view that the dovish central bank pivot is largely behind us. Both central banks have indicated guarded optimism about growth, partly due to their accommodative policy stance. The hurdle to cut rates again is high for the Fed, and the ECB may be concerned about the troublesome side effects of negative rates. Both central banks have also marginally raised their inflation forecasts. But the ECB remains further away from the price stability objective and – according to market pricing – would still be short of its target even in the fourth quarter of 2022. Sluggish inflation makes another dose of easing more likely in the euro area than in the U.S., where inflation is close to target. Yet markets have priced out any further easing by the ECB, while still maintaining a meaningful probability of the Fed cutting the federal funds rate next year.

Pivot pricing

Central bank rates and 1-year/1-year forwards, 2018-2019



There is no guarantee that any forecasts made will come to pass. Past performance is no guarantee of future results. Source: BlackRock Investment Institute with data from Bloomberg, December 2019. Data as of 4th December 2019. Notes: The chart shows the market pricing of policy rates in overnight index swaps on a one-year horizon starting in one year's time. Dotted lines show policy rates for each region; we use the midpoint of the Fed funds target range for the U.S.

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 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

- 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.
- The U.S. killing of the commander of Iran's proxy forces in the Middle East marks a major escalation in the U.S.-Iran conflict. Iranian retaliation is likely; energy infrastructure in the region is particularly vulnerable. Generally, we believe markets are underestimating political risks, especially in the Gulf, North Korea and in cyberspace. See our geopolitical 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. 6	Services/composite Purchasing Managers' Index (PMI) for the U.S., euro area, China, Brazil
Jan. 7	Euro area flash estimate inflation; U.S. factory orders
Jan. 9	German foreign trade, industrial production
Jan. 10	U.S. nonfarm payrolls

The U.S. nonfarm payrolls data for December will be the focus. Consensus estimates point to an increase of 172,000 jobs. This number pales in comparison to November's surprise surge, but would still indicate a solid labor market. The robust job market and resilient consumer spending have been underpinning the U.S. economic expansion that is more than a decade old. Services and composite PMI data could help shed light on the state of the consumer sector in the U.S. and other countries.

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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.

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