

Weekly commentary

March 9, 2020

BlackRock

Policy response to virus takes shape

- Central banks have started cutting rates to mitigate the virus shock – and governments are readying further actions. We see more to come.
- We recently downgraded our stance on risk to neutral due to material uncertainties associated with the outbreak and its impact.
- This week’s China’s lending data and U.S. consumer sentiment will offer a glance at the outbreak’s impact on the world’s top economies.

The coronavirus outbreak has continued to roil markets, even as significant monetary policy steps have been taken. Uncertainties related to the outbreak give public health officials a strong incentive to act aggressively to mitigate its human toll. These measures, though temporary in nature, slow economic activity, sometimes precipitously. We believe this will eventually set the scene for a strong rebound, but a decisive policy response is needed to safeguard fundamentals.



Jean Boivin
Head of BlackRock Investment Institute



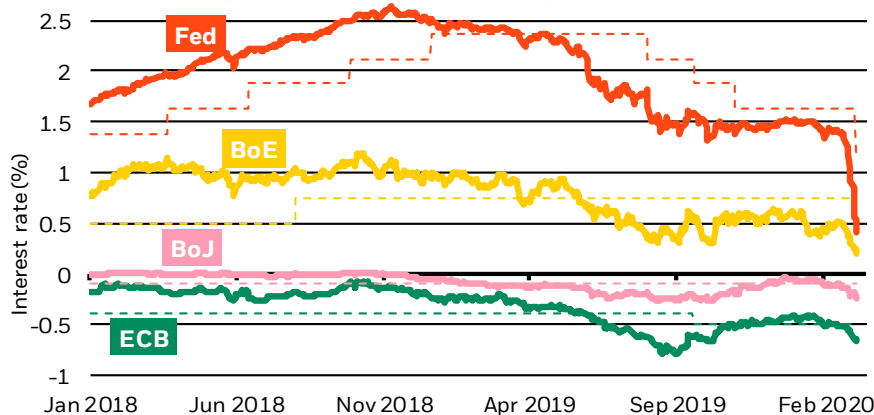
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Chart of the week

Central bank policy rates and market pricing of future rates, 2018-2020



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2020. Notes: Data are as of March 5, 2020. The solid lines show 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.

Policy can target three things in the face of this shock: prevent a sustained tightening of financial conditions; help stave off cash flow shocks that would threaten to shutter otherwise sound businesses; and support individuals whose incomes are eroded by the disruptions. We see a need for a decisive and pre-emptive policy response across these dimensions. The remaining space for traditional monetary policy tools such as rate cuts is limited, with interest rates near all-time lows. Simply using up that space – especially without coordination with fiscal policy – could quickly draw attention to the empty toolbox and backfire. The Federal Reserve cut interest rates last week, outside a policy meeting for the first time since the 2008 financial crisis. That rate cut failed to stabilize markets, which are now pricing in an even steeper drop in the Fed’s policy rates – as the chart shows.

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The only way to address the diminished monetary policy toolkit is to add more lines of defense, such as bringing in fiscal policy explicitly as part of the emergency response. This echoes our view that monetary-fiscal coordination is critical in dealing with the next downturn. We are seeing early signs of a response to the current shock. Fiscal policy is the space to watch. Europe’s finance ministers appear prepared to launch fiscal measures. U.S. officials are likely to take up greater fiscal action if events warrant it – beyond the \$8.3 billion in emergency spending approved last week – even in an election year with a divided government.

We expect policy responses across economies to be loosely coordinated – yet differentiated – due to the varied characteristics of economies as well as political and policy constraints. One example is the key funding sources of economies – and their implications on policy actions. The U.S. economy is relatively dependent on funding from capital markets. In economies that rely more on bank lending, policymakers have additional policy options to keep credit flowing, such as targeted liquidity operations in combination with regulatory relief. The Bank of Japan and European Central Bank (ECB) may have less room to cut rates, but can support the private sector by buying equities and corporate debt – a tool that the Fed doesn’t have. The Fed may cut its policy rate again later in the month, but at this stage we do not expect a renewed expansion of its balance sheet. We see the ECB announcing policy actions this week, likely putting more emphasis on targeted credit easing measures than the Fed.

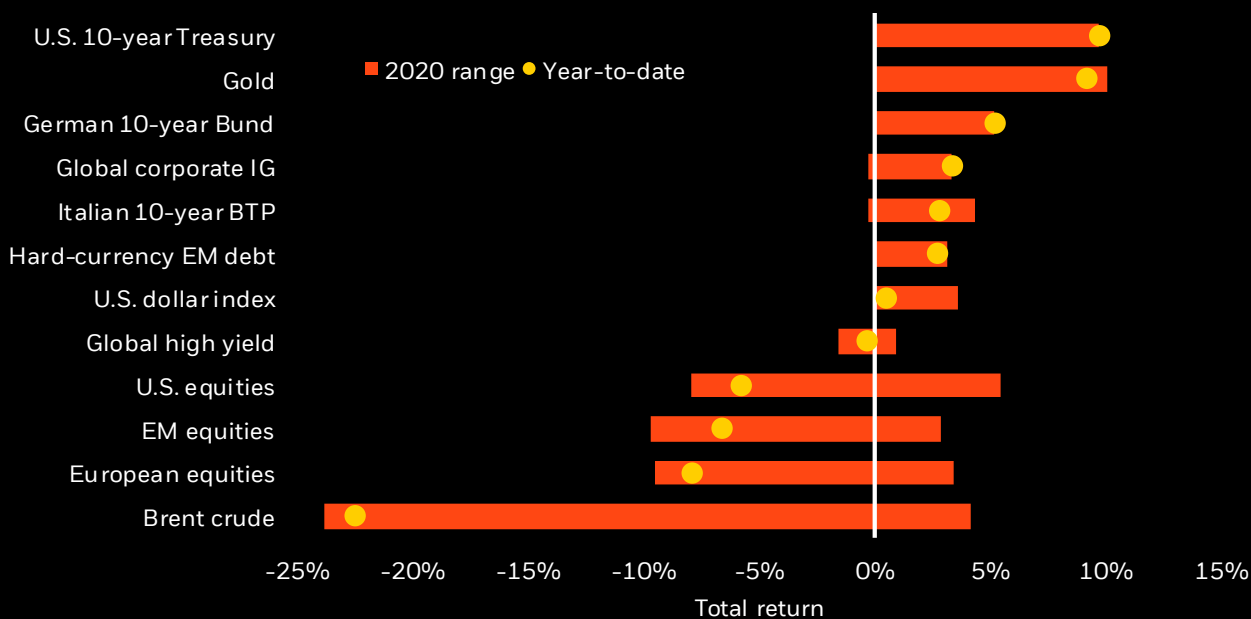
Bottom line: We see monetary policy responses as helpful, but they will be wasted without complementary fiscal and targeted liquidity measures. The coronavirus shock is similar to shocks caused by natural disasters in the sense that their impact on economic activity tends to be temporary. We see a sharp economic rebound once potential disruptions dissipate, and expect the global economic expansion to remain intact – albeit on a lower trajectory. Yet the unknown depth and duration of the shock add material risks, and markets will need greater clarity on the outbreak itself as well as the overall policy response before stabilizing. We believe investors should stay invested, but keep risk near benchmark weights. We have recently updated our views on equity factors – highlighting resilient exposure like quality and minimum volatility – and are still reviewing our regional equity and fixed income views.

Market backdrop

The spread of the coronavirus globally, and plunging oil prices after Saudi Arabia said to ramp up their oil output, sent global stocks tumbling. Worries about the economic impact of the outbreak grew, despite the Fed’s rate cut last week. The benchmark U.S. Treasury 10-year yield dropped to record lows below 0.5% as the perceived safe-haven asset attracted investors seeking shelter.

Assets in review

Selected asset performance, 2020 year-to-date and range



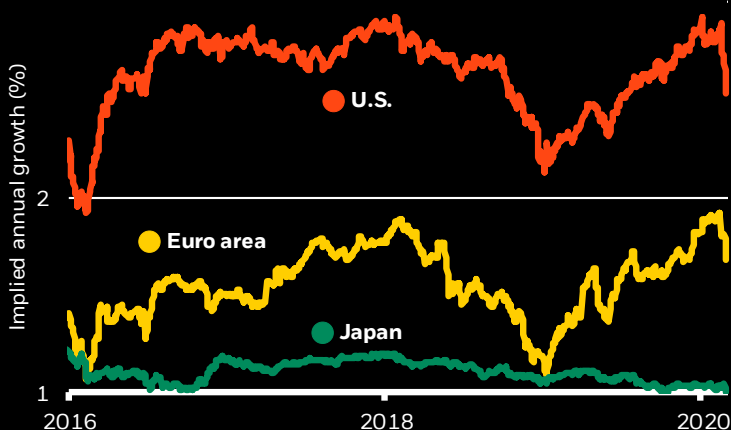
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, 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 financial conditions have tightened, despite a pronounced drop in sovereign bond yields. This was most pronounced in the U.S., where financial conditions are most impacted by financial markets. In response to this, the Fed surprised markets with a 0.5% rate cut. Other major central banks – such as the Bank of England and ECB – have issued statements saying they are ready to act if needed. But the space to cut rates is limited in economies such as Japan and the euro area, and rate cuts are only one part of the policy toolkit. Central banks could use a broader package of measures, including asset purchases, and other actions to provide liquidity to financial markets and to small- and medium-sized enterprises as well as using central bank swap lines to ensure U.S. dollar funding is available. Fiscal policy is also likely to be an important part of the policy response, especially public health spending and income support for people temporarily off work.

Tighter times

BlackRock Financial Conditions Indicators, 2016–2020



Sources: BlackRock Investment Institute and Bloomberg, March, 2020. Notes: This chart shows the rate of G3 GDP growth implied by our financial conditions indicator, based on its relationship with our Growth GPS. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass.

Investment themes

1 Growth downshift

- We see the coronavirus outbreak and containment measures causing near-term disruption to global economic activity. This may push Japan and the euro area to the brink of technical recession.
- We expect a recovery in activity once disruptions dissipate, but the depth and duration of the trough are highly uncertain and these unknowns could weigh on consumption and investment.
- The main risk to our view: a broadening of the outbreak triggers a premature end to the cycle.
- The macro impact – within China and beyond – is primarily driven by extensive containment measures.
- Our macro regime work puts the U.S. business cycle in a slowdown regime – but we could see supply chain disruptions trigger a market-unfriendly mix of slowing growth and rising inflation over time.
- **Market implication:** We downgrade our moderate pro-risk stance and turn neutral on equities and credit.

2 Policy action

- Major central banks are likely to follow suit after the Federal Reserve cut rates between meetings. Any further and sustained tightening of financial conditions will likely be met by additional easing. The European Central Bank and Bank of Japan have less space for rate cuts but more on targeted interventions to ensure the flow of credit.
- China has eased monetary policy as a first response to cushion the drag from the coronavirus outbreak, and has rolled out other measures to help businesses stay afloat.
- Fiscal policy will likely be part of the toolkit, with governments ramping up public health spending, providing relief to the hardest-hit industries and regions, and supporting individuals that have fallen ill or are forced to work less.
- The U.S. and China have strong incentives to maintain the pause on their trade conflict, though there may be more turbulence ahead in global trade, particularly if U.S. trade measures shift to Europe.
- **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 has worked during the virus-related equity volatility. The moves also confirmed that some developed market government bonds, such as German bunds, offer less diversification 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 undermine the portfolio ballast role of government bonds.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a new phenomenon that will carry a return advantage over years and decades.
- Tensions over technology rivalry remain high between the U.S. and China. 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

Mar. 10–15 China total social financing, new loans

Mar. 12 ECB monetary policy meeting

Mar. 11 U.S. Consumer price index (CPI)

Mar. 13 University of Michigan surveys of consumers

China’s total social financing data will be a focus, with markets expecting weaker new loan growth as the outbreak has stalled lending to consumers. The lending figures come on the heels of data pointing to plunges in activities in both manufacturing and services sectors. The University of Michigan survey could shed some light on the resilience of U.S. consumers that has underpinned the economy in recent years, as the outbreak spreads in the world’s largest economy.

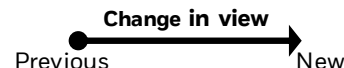
Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, February 2020

Asset	Underweight	Neutral	Overweight
Equities	We downgrade global equities to neutral. The coronavirus outbreak is disrupting economic activity and supply chains. The outbreak also poses risks to corporate earnings, in our view. Equity valuations still look reasonable, and accommodative monetary policy is a support.		
Credit	We cut our overall view on credit to neutral. Downside risks and increased uncertainty around the economic outlook reduce our preference for risk assets. We could also see a risk of temporary liquidity crunches. We remain neutral as coupon income is king in a world starved for yield, especially at a time government bond yields are hovering near record lows.		
Government bonds	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view, although the bar for taking such action looks high in the U.S. and Europe. We favor regions that have policy space, such as the U.S.		
Cash	We maintain our neutral position on cash for risk mitigation. 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.	
	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.	
	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.
	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.
	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.
	Momentum			We upgrade momentum to neutral. The factor has outperformed amid the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend-paying bond proxies.
	Value			We downgrade value to underweight. Value tends to perform best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
	Minimum volatility			We upgrade min-vol to overweight. We prefer its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
	Quality			We hold quality as an overweight. We like that it tends to be resilient in late-cycle periods, despite their relatively high valuations.
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.
	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.
	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.
	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.
	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.
	Global high yield			We keep global high yield as an overweight, supported by stable monetary policy and the prospect of a growth inflection.
	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 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.
	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.

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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