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WEEKLY COMMENTARY • JUNE 24, 2019

Key points

1. The European Central Bank and Federal Reserve have shifted toward more dovish stances. We examine the implications for our bond views.
2. Stocks and bonds rallied last week on ECB and Fed comments. Oil spiked after Iran shot down a U.S. drone. U.S. factory data disappointed.
3. We could see another temporary U.S.-China trade truce at this week's G20 summit, but we see tensions as structural and long-lasting.

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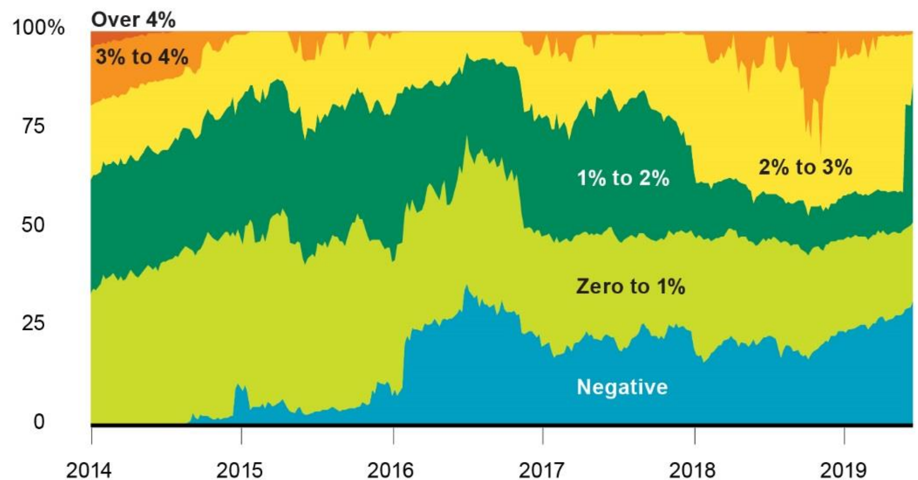
1 Evolving bond views as central banks shift

A clear message from ECB President Mario Draghi last week kicked off a dovish shift by major central banks -- from patience to inching toward more stimulus. We see the ECB and the Fed likely to ease soon. Yet while market expectations for ECB easing appear reasonable, expectations for the Fed seem excessive. We believe government bonds still are key stabilizers in strategic portfolios amid rising macro uncertainty, but we are turning cautious on long-term U.S. Treasuries in the short run.

Chart of the week

Developed market government bond yield distribution, 2014-2019



Sources: BlackRock Investment Institute, with data from J.P. Morgan and Refinitiv Datastream, June 2019. Notes: The chart areas show the share of bonds by market value within the J.P. Morgan Global Developed Bond Index with yields in each range.

Major central banks are turning more dovish to address inflation shortfalls and extend the expansion. In a speech, the ECB's Draghi said rate cuts and other options were on the table to support the eurozone unless growth and inflation pick up soon. Asset prices immediately reflected the dovish tone. The front-end German bund yield dropped to an eye watering year-to-date low of -0.75% after the news. The prospect of an ECB going even more negative on rates and/or restarting quantitative easing has helped drag the share of developed market government bonds with negative yields back to 2016 highs. See the bottom right corner of the chart. Also contributing: market expectations that other central banks, including the Bank of Japan, will ease later this year. The Fed left rates unchanged, but signaled it was closely monitoring if more stimulus may be warranted. The FOMC cut the word "patient" from its policy statement and eight participants signaled lower rates would be appropriate this year.

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The dovish shift supports our view that the global expansion has room to run, albeit with moderating growth. We now see reduced risks of a recession and of overheating over the next two years. Yet we see rising trade and geopolitical tensions posing downside risks to growth expectations -- and are debating the potential longer-term consequences of a reversal in the globalization trend, such as higher inflation.

The Fed and other central banks are now considering adopting so-called make-up strategies, such as average inflation targeting, to address inflation falling short of their targets, as we detailed in our recent Macro and market perspectives. Yet the shift in this direction has not been uniform. In his recent speech, Draghi seemed to signal the ECB's willingness to put such strategies to work in the near term. The ECB out-doved the Fed relative to market expectations going into the week. We expect this trend will persist. We believe market expectations of U.S. policy easing have gone too far. Recent U.S. economic data outside manufacturing have been at trend. We see the Fed likely cutting rates in July as insurance against escalating trade conflicts, but failing to deliver on the four quarter-point rate cuts through 2020 markets are expecting. In contrast, Europe has long been facing structural challenges in getting inflation back to target. We see Draghi's speech paving the way for further policy easing, meeting market expectations during the remainder of his term as central bank president.

Against this backdrop, we remain positive on risk assets and recognize that yields may fall further. We still believe government bonds are key for providing portfolio ballast over the longer term. Yet investors are no longer being compensated enough for duration risk in U.S. Treasuries, in our view, given that the market appears to be pricing in too much Fed easing. This is why we are becoming more cautious on long-term U.S. government bonds from a tactical perspective. We see Europe as a different story: The amount of easing priced into markets appears reasonable. We see an opportunity for U.S.-dollar based investors to add exposure to European government bonds. Yields look much more attractive after hedging back into U.S. dollars thanks to the hefty U.S.-euro interest rate differential. Negative rates are a challenge for eurozone investors, but a relatively steep yield curve is a plus. In the light of these developments, we are in the process of reviewing our tactical asset allocation views and will release the full updates in our upcoming midyear outlook.

2 Week in review

- Risk assets rallied after dovish comments from the ECB and Fed. ECB President Mario Draghi said rate cuts were an option if the eurozone economic outlook does not improve, sending the share of developed market government debt with negative yields to 2016 levels. The Fed inched closer to signaling it is ready to cut rates, amid the risks trade tensions pose to the domestic U.S. outlook.
- The U.S. Empire State manufacturing index posted its largest-ever drop into negative territory, while the Philadelphia Fed manufacturing index tumbled from the prior month. U.S. President Donald Trump said U.S. and China trade officials would restart talks ahead of this week's G20 summit in Japan. Oil prices spiked after Iran shot down a U.S. drone aircraft. The U.S. Senate voted to block Trump's Saudi arms deal.
- UK Conservative Party lawmakers concluded five rounds of voting in the contest to replace Theresa May as Prime Minister. The final two candidates will be put to a vote-by-mail of Conservative Party members, with the winner due to be announced July 22.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.2%	18.9%	9.5%	1.9%
U.S. Small Caps	1.8%	15.6%	-7.0%	1.6%
Non-U.S. World	2.7%	13.3%	1.0%	3.1%
Non-U.S. Developed	2.2%	13.7%	0.7%	3.3%
Japan	0.8%	7.4%	-6.0%	2.5%
Emerging	3.8%	10.3%	0.5%	2.7%
Asia ex-Japan	4.1%	10.0%	-2.7%	2.5%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.2%	4.7%	7.2%	2.1%
U.S. TIPS	1.0%	5.9%	5.2%	2.2%
U.S. Investment Grade	1.0%	9.1%	10.3%	3.2%
U.S. High Yield	1.0%	10.0%	6.9%	5.8%
U.S. Municipals	0.2%	5.0%	6.7%	2.0%
Non-U.S. Developed	1.2%	4.5%	3.8%	0.6%
EM $ Bonds	1.5%	11.2%	12.4%	5.6%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	5.1%	21.2%	-10.8%	$ 65.20
Gold	4.3%	9.1%	10.4%	$ 1,399
Copper	2.6%	0.1%	-12.0%	$ 5,971

Currencies	Week	YTD	12 Months	Level
Euro/USD	1.4%	-0.9%	-2.0%	1.14
USD/Yen	-1.2%	-2.1%	-2.4%	107.32
Pound/USD	1.2%	-0.1%	-3.8%	1.27

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of June 21, 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

June 26-27 First Democratic primary debates in the U.S.

June 27 Germany harmonised inflation; eurozone consumer confidence

June 28 Japan consumer price inflation, industrial production; eurozone inflation; U.S. consumer sentiment

June 28-29 G20 summit

June 30 China NBS Manufacturing PMI

U.S. President Donald Trump and China's President XI Jinping are scheduled to meet at the G20 to discuss trade frictions, but a comprehensive deal appears unlikely this week. At best, we expect a truce of some sort—a pause in the escalation of tariffs, followed by renewed negotiation. A deal later this year is possible but would face significant challenges in implementation and enforcement -- and we see structural tensions persisting. Read more at our updated BlackRock geopolitical risk dashboard.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. We like selected Southeast Asian markets but recognize a worse-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	—	We are cautious on U.S. Treasury valuations, but still see the bonds as important portfolio diversifiers. We see recent moves lower in yields as excessive and advocate patience before increasing exposure. We prefer shorter-dated and inflation-linked bonds and expect a gradual yield curve steepening, driven by still-solid U.S. growth and the Fed's stated willingness to tolerate temporary inflation overshoots.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	Increased demand for income amid stable monetary policy, signs of more conservative corporate behavior and constrained supply remain supportive. We prefer an up-in-quality stance overall, but recent spread widening may also offer an attractive opportunity in BBB-rated credits. We favor bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. European sovereign bonds offer an attractive income opportunity for U.S.-dollar based investors on a currency-hedged basis.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income, yet valuations are relatively rich after a rally this year. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to its U.S. counterparts.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia. Portfolio rebalancing could cause material capital inflows into China, as the country opens its markets to foreign capital.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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