

Weekly commentary

Oct. 21, 2019

BlackRock

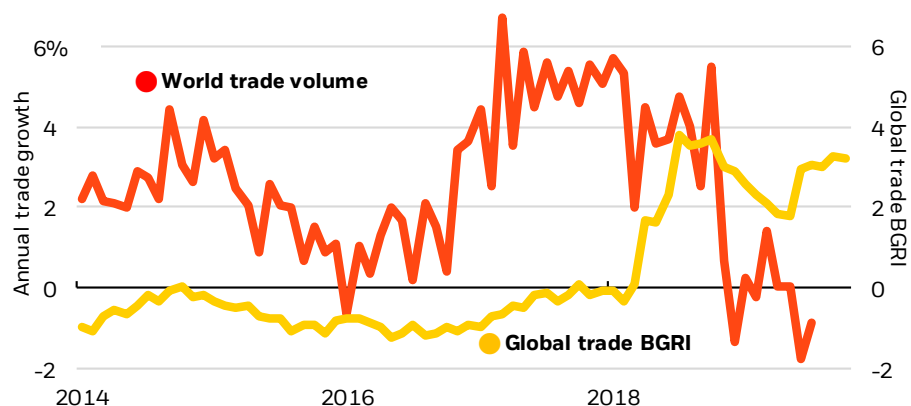
Geopolitics' clout on markets persists

- A perceived de-escalation in U.S.-China tensions and Brexit has driven up risk assets, yet we see geopolitical risks staying at elevated levels.
- Signs that weakness caused by the protectionist push is spreading beyond manufacturing have cast a shadow on the growth backdrop.
- The U.S. and euro area purchasing managers' indexes (PMIs) due this week could offer a glimpse at the health of the global economy.

The impact of the protectionist push on the global economy and markets is playing out: Global growth is slowing, and geopolitical volatility has increasingly swung markets. A perceived easing of U.S.-China trade tensions and the risk of a no-deal Brexit has supported risk assets since early October. Yet we expect more twists and turns in coming months, and see geopolitical risks staying elevated in the longer term. We advocate for raising portfolio resilience.

Chart of the week

World trade growth and Global trade BGRI, 2014-2019



Sources: BlackRock Investment Institute, with data from U.S. Customs and Border Protection, Statistics Netherlands and Refinitiv Datastream, October 2019. Notes: BGRI stands for the BlackRock geopolitical risk indicator. We identify specific words related to geopolitical risk in general and to the top-10 risks including global trade. We then use text analysis to calculate the frequency of their appearance in the Refinitiv Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We adjust for whether the language reflects positive or negative sentiment. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.

Our [BlackRock geopolitical risk dashboard](#) helps track geopolitical risks and their potential market impact. It features both data-driven market attention trackers (BlackRock geopolitical risk indicators, or BGRIs) and judgment-based assessments of our top 10 risks. The Global trade BGRI has historically showed a negative relationship with the world's trade growth. A sharp rise in the BGRI in 2018 preceded a steep decline in the growth of global trade. The BGRI has since stayed at elevated levels and trade growth has languished. See the chart above. This underpins our view that trade tensions and other geopolitical risks have become key drivers of the global economy. Relatively high market attention to these risks suggests they are likely priced in to some extent.



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Geopolitical risks have come to the fore in 2019 as a key market and economic driver, as detailed in our recently updated [Global investment outlook](#). The marked escalation in the U.S.-China conflict in particular has injected additional uncertainty into business planning, threatening to further weaken economic activity. Markets breathed a collective sigh of relief after the U.S. and China ended the latest round of trade talk with more conciliatory gestures. Yet no agreed text was produced. The U.S. is maintaining all existing tariffs on Chinese goods and is set to launch a new round of tariff increases on Dec. 15. A key signpost: The U.S. and China are aiming to agree on the text of a limited trade deal for the two countries' leaders to sign at the Asia-Pacific Economic Cooperation (APEC)'s summit on Nov. 16-17. More senior-level meetings are required to achieve the goal, likely bringing more twists and turns. We may see a temporary truce heading into 2020, but view the U.S.-China competition as structural and long-lasting. Tensions between the two countries are broadening out to include technological and financial dimensions.

Elsewhere, markets got more optimistic that the UK would not crash out of the EU, after both sides agreed to a new deal. The British pound has rebounded sharply from early October lows. Yet any resolution still faces hurdles. The UK Parliament in a Saturday sitting voted to withhold its approval for the deal until relevant legislation is passed, forcing the UK government to ask the EU for an extension to the Oct. 31 deadline. Our base case is that Parliament ultimately passes a deal, as early as this week or possibly after a general election. The range of outcomes remains wide, but we see the tail risk of a no-deal Brexit as very unlikely.

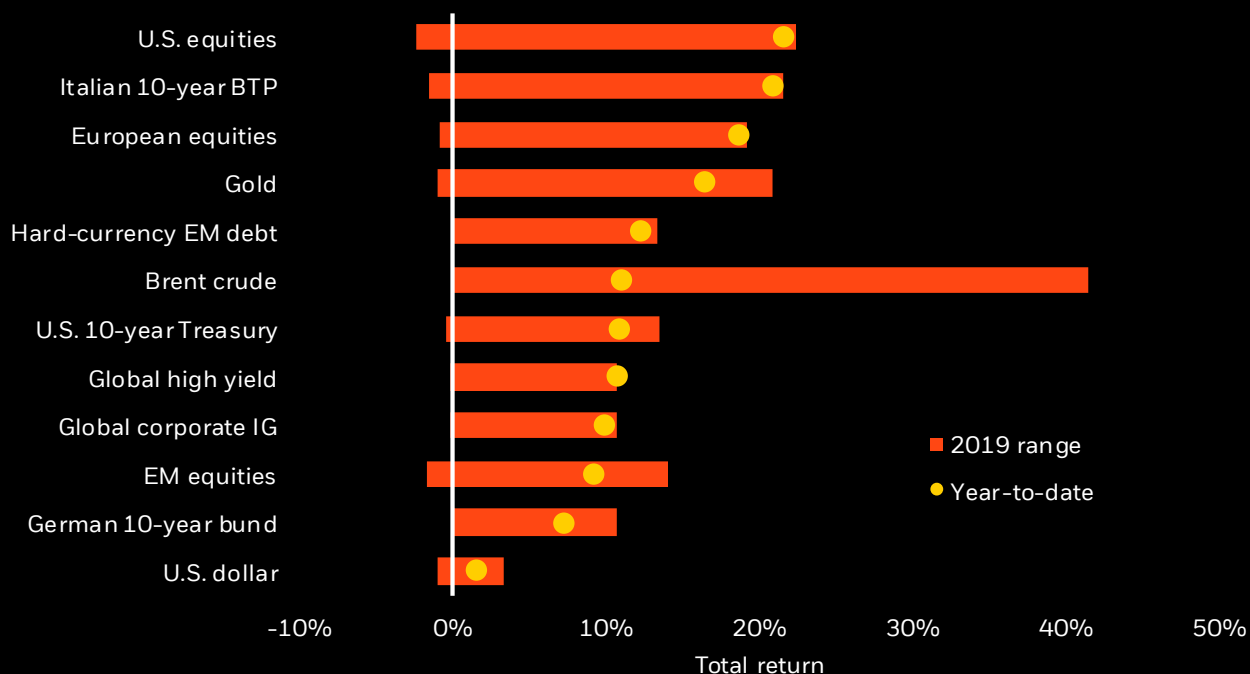
Bottom line: Geopolitical frictions will remain a powerful driver of the global economy and markets despite the apparent easing in some risks recently. We expect a pickup in global growth in the next six to 12 months as policy stimulus gradually makes its way to the real economy. Yet we could see bumps on the road in the near term, as economic data remains weak and geopolitics uncertain. This suggests we should be thinking about ways to protect portfolios against potential risks. We favor the more defensive parts of the U.S. equity market, such as the min vol and quality style factors. We also see government bonds continuing to play an important role in building portfolio resilience – even at low yield levels.

Market backdrop

A détente in geopolitical frictions on two key fronts – U.S.-China tensions and Brexit – has boosted risk assets. Yet signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing have cast a shadow on the growth backdrop. Major central banks have taken a dovish stance – the Federal Reserve has cut rates in line with market expectations, following the European Central Bank's broad stimulus package. We expect a pickup in global growth in the next six to 12 months, yet see limits to how much monetary easing can be delivered in the near term. Monetary policy is no cure for the weaker growth and firmer inflation pressures that may result from sustained trade tensions.

Assets in review

Selected asset performance, 2019 year-to-date and range



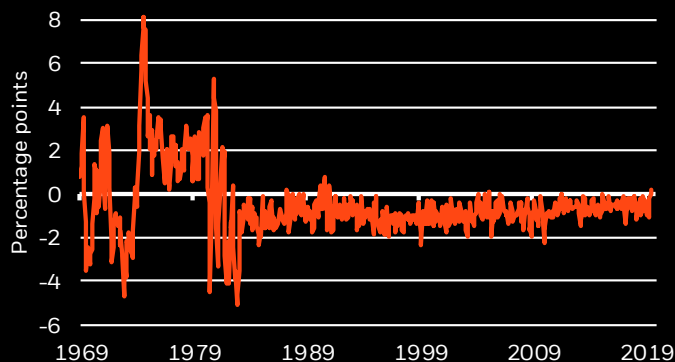
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end 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. BIIM1019U-988642-2/5

Macro insights

Are global trade tensions impacting the economy mainly through a “demand shock” or a “supply shock?” The answer has significant market implications, in our view. If the main impact of trade friction is weaker demand, we should be experiencing broad disinflationary pressures as growth slows – allowing core sovereign bonds to play their role as hedges against risk-off events. If supply shocks are dominant, inflation may increase (as businesses relocate supply chains, the cost of production rises) even as growth declines – leading to falls in both equity and bond prices. It is important to keep an eye on inflation in order to determine whether we should expect a demand shock or a supply shock. The 1970s and early 1980s were dominated by upside U.S. inflation surprises. The decades since then have been characterized by downside inflation misses as central bank targeting dragged down inflation faster than expected. Yet in the past few months, inflation has been higher than expected again.

Lowflation regime

U.S. inflation shocks, 1969-2019



Sources: BlackRock Investment Institute and the U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream, October 2019. Notes: The chart shows the difference between the actual and expected inflation outcomes. We use a statistical model to estimate inflation expectations back to 1969, drawing on the relationship between the actual U.S. Consumer Price Index (CPI), GDP and policy interest rates over trailing three-year periods. We use these regressions to estimate the expected annual inflation rate in three months' time.

Investment themes

1 Protectionist push

- The U.S. and China agreed on an outline of what the first part of a limited deal on trade may look like, marking a temporary de-escalation in tensions. The lack of a written agreement points to ongoing negotiations.
- No tariff was reduced, but a tariff increase set for Oct. 15 was scrapped. There was little movement on longer-term strategic issues. The U.S. has stuck to its harder stance on technology, national security and human rights concerns.
- Risks of a no-deal Brexit have diminished. A delayed vote in the UK Parliament on a new deal forced the government to ask the EU for an extension to the Oct. 31 deadline, yet we see a deal ultimately passing.
- Persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle – a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- **Market implication:** We favour reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- The record-long U.S. economic expansion looks unlikely to morph into a deeper downturn any time soon, supported by healthy household spending.
- Central banks have eased policy significantly with the aim of offsetting the trade shock and to sustain the economic expansion in the face of a deepening manufacturing recession.
- We do not see the Fed's resumption of overnight repo operations to alleviate short-term funding pressures as a form of QE. The Fed is specifically targeting the Fed funds rate and not looking to shape long-term rate expectations.
- The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct impact of tariffs and in the long term due to the hit to production capacity, complicating the case for policy easing.
- 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*. Absence of a credible plan is contributing to market anxiety, and adding to the rush into the perceived safety of government bonds.
- **Market implication:** We like U.S. equities and EM debt. We are overweight eurozone government bonds: a relatively steeper yield curve brightens the appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- Most government bonds play an important role in building portfolio resilience – even at low yield levels – both on a tactical basis and in long-term portfolios.
- Last month's sharp reversals in the momentum and value factors show the importance of minimizing portfolio exposure to pockets of the market where pricing appears stretched.
- **Market implication:** We prefer U.S. Treasuries over German bunds for portfolio diversification on a strategic basis. The recent underperformance of bunds relative to Treasuries in recent risk-off events suggests core euro area government bond yields are approaching their perceived effective lower bound.

Week ahead

Oct. 24 – The U.S. and euro area PMIs will offer some hints on the health of the global economy. PMIs have declined in both economies, led by manufacturing in the euro area. Yet we believe easier financial conditions underpin our view that global manufacturing weakness is unlikely to lead to a broader economic downturn in the near term.

Oct. 24 – The European Central Bank’s outgoing president Mario Draghi’s last monetary policy meeting. Markets do not expect any rate cut, and will focus on the forward guidance.

Asset views

Views from a U.S. dollar perspective over a 6-12 month horizon

Asset class	View	Comments
Equities	U.S.	▲ A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like min-vol and quality, which have historically tended to perform well during economic slowdowns.
	Europe	— We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼ We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	— We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼ We have downgraded Asia ex-Japan equities to underweight due to the region’s China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region’s debt instruments instead.
Fixed income	U.S. government bonds	▼ We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	— Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis’ tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	— We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲ The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for euro area investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	— Renewed ECB purchases of corporate debt and a “lower for even longer” rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲ We like EM bonds for their income potential. The Fed’s dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina’s woes) and in countries not directly exposed to U.S.-China tensions.
Asia fixed income	— The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing. We have reduced overall risk and moved up in quality across credit as a result.	

▲ Overweight — Neutral ▼ Underweight

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