

Weekly commentary

Nov. 11, 2019

BlackRock

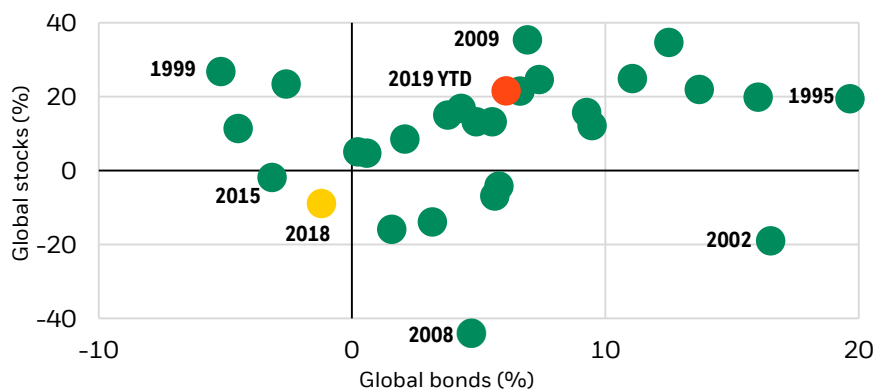
Debating our 2020 outlook

- Many drivers of markets in 2019 look to be approaching their limits. We debate what lies ahead at our 2020 outlook forum this week.
- We see growth stabilizing but are watching for signs of manufacturing weakness spilling over while central banks likely hold the line.
- Economic data may confirm a technical recession in Germany, but sentiment data should show signs of euro area growth stabilization.

Two key themes have driven financial markets in 2019: the drag on economic activity and risk assets from trade tensions (our “protectionist push” theme); and a dovish pivot by central banks that has supported the expansion (“stretching the cycle”). What lies ahead? We believe these two market drivers may be testing limits over the next year. That’s the theme of our two-day forum in New York this week, where more than 100 BlackRock attendees will debate our 2020 outlook.

Chart of the week

Total annual returns of stocks and bonds, 1991-2019



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. November 2019. Notes: Global stocks are represented by the MSCI ACWI index. Global bonds are represented by the Bloomberg Barclays Global Aggregate Bond Index. Total returns are shown in U.S. dollars. 2019 returns are through Nov. 5.

BlackRock’s senior decision makers and portfolio managers gather twice a year to debate the market outlook. One topic likely to come up in our discussions this week: a reversal of fortunes from one year ago, when both stocks and bonds were on track for negative annual returns – a rare event. See the yellow 2018 dot in the chart above. The culprits: uncertainty over trade disputes, late-cycle concerns and tighter financial conditions. At our forum last November, we saw equities and bonds both eking out positive returns this year, the former fueled by the ongoing global expansion and reasonable valuations even in the face of slowing earnings growth; the latter by central banks’ dovish pivot, growth downgrades and subdued inflation. The rebound in both asset classes that we anticipated in our 2019 outlook has occurred, though its magnitude has been more than we expected. See the orange 2019 dot above. We didn’t fully anticipate how much valuation multiples would rise on central bank easing.



Jean Boivin

Head of the BlackRock Investment Institute



Elga Bartsch

Head of Macro Research – BlackRock Investment Institute



Mike Pyle

Global Chief Investment Strategist – BlackRock Investment Institute



Scott Thiel

Chief Fixed Income Strategist – BlackRock Investment Institute

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Where do we go from here? That’s the question we’ll be debating this week. Our answer will depend on our discussions around the outlook for the economy, policy, and geopolitics. Thanks to a robust global consumer and dovish central banks, we believe the expansion is unlikely to morph into a deeper downturn any time soon. At [our 2019 midyear outlook](#) forum, we downgraded our growth outlook due to the protectionist push. We now see global growth stabilizing thanks to a lull in trade tensions and easier financial conditions.

Trade disputes and geopolitical frictions became key drivers of the economy and markets this year (see [the November update](#) to our *Q4 2019 Global investment outlook*). This marked a sharp reversal from decades of increasing openness and injected uncertainty into business planning, weakening economic activity. Yet there have been signs recently that global manufacturing activity may be bottoming and that U.S.-China trade tensions may be abating, at least temporarily. This pause in the protectionist push has helped fuel recent risk asset rallies – and helps keep us moderately pro-risk. A potential wildcard for 2020 that we’ll be debating: The market implications of the U.S. presidential election campaign and its result.

We’ll also be taking a closer look in our forum discussions at the potential next steps in monetary (and fiscal) policy and their investment implications. Global central banks have delivered an unusual late-cycle dovish pivot to extend an already-long economic expansion (see our [Nov. 4 Weekly commentary](#)) and combat a drag from rising trade tensions. We will be debating the extent to which this easing story is behind us. Reasons it could be nearing an end: Inflation is creeping higher in the U.S. – and monetary policy has limited capacity to deal with the side effects of trade protectionism. We also believe central banks have little ammunition left to address any future [meaningful economic downturn](#). A key question: how much of a bigger role can fiscal policy play? We see scope for modest stimulus in Europe and China.

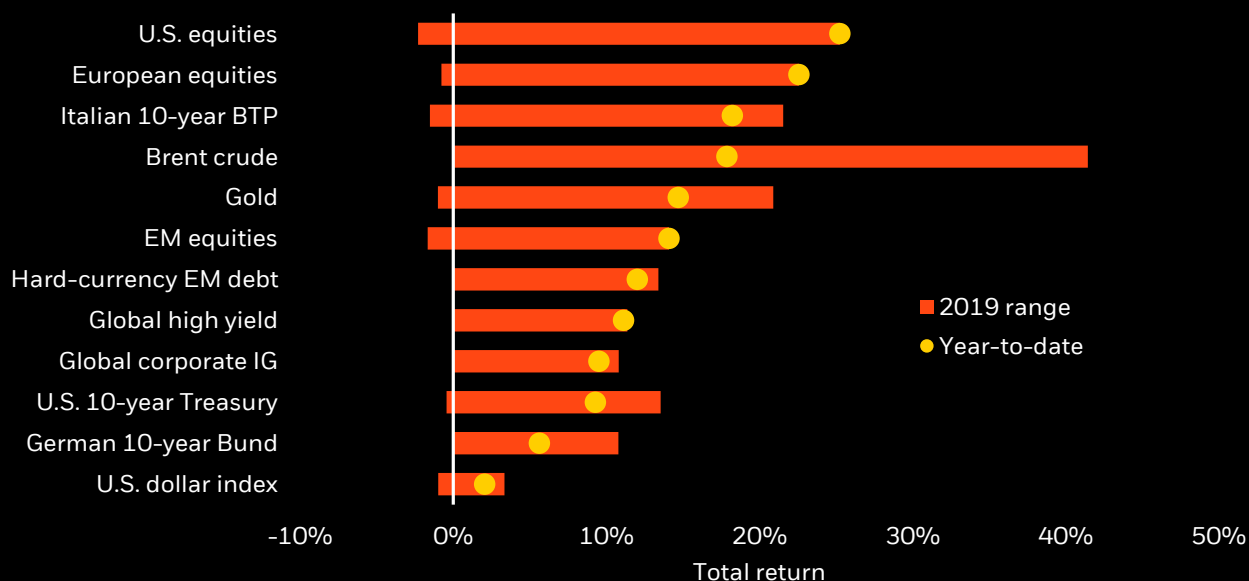
Lastly, we will debate the market implications of our base case of stabilizing growth. These include a potential rotation within equity markets away from defensive stocks toward cyclical ones. The investing conclusions from our debates – including our tactical asset allocation views – will be released in our *2020 Global investment outlook* on Dec. 9.

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, and for signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing. Markets have tempered expectations of further Fed rate cuts, suggesting the dovish pivot by major central banks has run its course for now. Monetary policy is no cure for the weaker growth and firmer inflation pressures that may result from sustained trade tensions. We expect growth to stabilize over the next 6 to 12 months, fueled by loose financial conditions. See our [macro data dashboard](#).

Assets in review

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



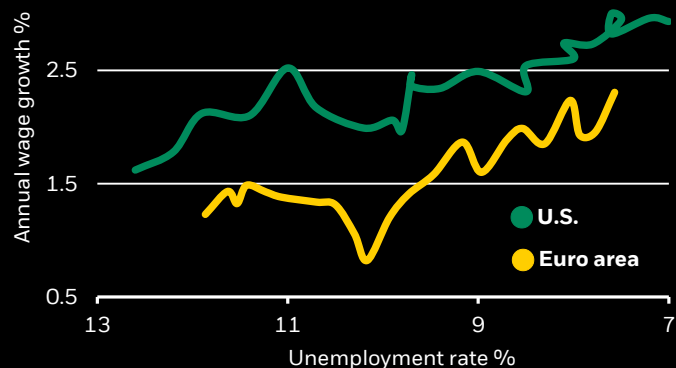
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end 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. BIIM1119U-1007688-2/5

Macro insights

Growth is steady in the U.S. and euro area, unemployment rates are near cycle lows and wages are growing. So why is inflation still contained? Our Phillips curve models show that economic slack has disappeared in both the U.S. and euro area relative to pre-crisis levels, and input costs are neutral-to-supportive for inflation. It is depressed long-term inflation expectations – especially in the euro area – that are holding inflation down. Could these expectations pick up? Our Phillips curve models suggest that CPI inflation is not responding to tighter labor markets, but wage inflation has been. As the labor market tightens, wage growth in both the U.S. and euro area has ticked up – a wage Phillips curve remains in place. A mildly overheating economy – consistent with monetary easing and robust payrolls growth – could provide the inflationary environment that pushes up expectations. Our BlackRock Inflation GPS already suggests some upside pressure on U.S. core inflation.

Work and wages

U.S., euro area wage growth, unemployment, 2014-2019



Sources: BlackRock Investment Institute, Bureau of Labor Statistics, Eurostat and ECB, November 2019. Notes: The chart shows the correlation between the unemployment rate and year-on-year wage growth in the U.S. and the euro area between 2014 and 2019. For the U.S. we use the U6 unemployment rate - which includes workers who are part time purely for economic reasons - so that we can compare it more directly with the seasonally adjusted euro area figure, which already includes full- and part-time workers.

Investment themes

1 Protectionist push

- U.S. and Chinese negotiators are working toward a “phase 1” trade deal. A limited deal may be signed by the two countries’ leaders in November, but timing is uncertain with the cancellation of the APEC Summit in Chile.
- All existing tariffs remain in place. The next round of tariff increases is set for December. Structural issues over technology, national security, and human rights make a comprehensive deal unlikely.
- 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 midyear.
- 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.
- Risks of a no-deal Brexit have diminished. Yet a general election on Dec. 12 has created uncertainty on what follows.
- **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 manufacturing recession.
- Yet we believe the Fed has finished its late-cycle insurance rate cuts and is on hold for several months barring a sharp growth downturn or a risk asset selloff. China has stuck to a stable monetary policy stance, even in the face of an economic slowdown.
- 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.
- Markets have trimmed expectations of further Fed easing. We expect growth to stabilize over 6-12 months, thanks to loose financial conditions. That will take the reins in supporting risky assets. See the macro insights box above.
- **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

Euro area data –Third-quarter gross domestic product (GDP) growth and German business surveys will be in focus. Markets will watch for further signs of improving or stabilizing growth in the euro area and in Germany. Consensus estimates for GDP growth and recent PMI data point to Germany’s economy entering a technical recession, which data may confirm. Yet there have been some recent signs of growth improvement, including a rebound in German industrial orders. The German ZEW Economic Sentiment will be key for gauging Germany’s economic outlook.

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 parts 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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