

BLACKROCK INVESTMENT INSTITUTE



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Key points

- 1 We would look to buy emerging market debt on any material price dip given a solid near-term outlook.
- 2 Fourth-quarter earnings season was in full gear last week. Global equities fell and bonds rallied. European economic data disappointed.
- 3 Talks between U.S. and Chinese trade officials this week are crucial ahead of a scheduled increase in U.S. tariffs on Chinese goods.

1 Exploring the opportunity in EMD

Emerging market debt (EMD) has rallied sharply this year, bouncing back from a tough 2018. Is now a good time to add exposure? We would be buyers on any material sell-offs, as we see fundamentals remaining supportive in coming quarters. Our overall view on emerging markets (EMs) favors equities over debt, yet we believe EMD offers attractive income for bond portfolios.

Chart of the week

EMD and U.S. investment grade yields, 2014-2019



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 Thomson Reuters, February 2019. Notes: Local-currency emerging market debt (EMD) is represented by the real yield of the J.P. Morgan GBI-EM Global Diversified Composite Index. Hard-currency EMD is denominated in major currencies (primarily the U.S. dollar) and is represented by the blended yield to maturity of the J.P. Morgan EMBI Global Diversified Index. U.S. investment grade is represented by the yield of the Bloomberg Barclays U.S. Corporate Index.

This year's EMD rally is evident in how both local- and hard-currency EMD yields have fallen significantly as bond prices have risen. Yield spreads between EMD and U.S. investment grade bonds have tightened as a result. Yet EMD yields remain attractive on an absolute and relative basis over the longer term, as the chart shows. Yield spreads between hard-currency EMD and investment grade U.S. bonds hit highs late last year not seen since early 2016. Spreads remain wide in the context of the last few years, even with EMD's recent outperformance over investment grade and high yield. A reason EMD valuations still appear reasonable: The asset class took a hit last year as the Federal Reserve raised interest rates and the U.S. dollar (USD) appreciated. The backdrop for the asset class this year appears very different.

A different backdrop

We see three major drivers of this year's EMD rally, all likely to persist into the second quarter. The most important, in our view: The policy backdrop has quickly turned more supportive. A U.S.-led slowdown in global growth as the economy enters a late-cycle phase has prompted major central banks to slow their planned pace of normalization. The Fed's swift pivot from tightening to a policy pause has helped spur demand for EMD, as has the subsequent waning of USD strength. A pause in the Fed's hiking cycle eases the burden on EMs with high external debt loads. A softer or stable USD supports EM currencies and underpins local currency debt returns.

The second driver – the most underappreciated, in our view: large demand meeting tightening supply. EMD experienced sharp inflows along with other fixed income risk assets in early 2019. At the same time, market volatility led many EM issuers to postpone offering new debt: January issuance was well below year-earlier record levels. We expect the new-issue market will take time to restart in earnest. Until then, limited new supply should underpin the market. Another driver: Our [indicator](#) shows market attention to geopolitical risk has subsided modestly since late 2018, on easing concerns around a significant near-term escalation in U.S.-China trade tensions.

The growth story in EMs is also generally improving following weakness last year. We see policy easing underpinning a modest growth reacceleration in China during the first half of 2019. More steady growth in EMs should help cushion slowing global growth. The risks to our view: An escalating U.S.-China trade conflict, a return of recession fears or an inflation resurgence sparking earlier-than-expected Fed tightening. U.S.-China trade negotiations look to be progressing, though frictions related to competition for global technology leadership are likely to persist. We have become less concerned about USD strength and see the Fed on hold until at least the second half. Bottom line: We would look to increase EMD exposure on any price setbacks in the first half, and we maintain our neutral view overall. EMD valuations and income potential are relatively attractive, but the value case is less compelling than it was earlier this year. A relatively stable USD outlook means no clear advantage in hard- over local-currency EMD.

2 Week in review

- More than half of MSCI ACWI firms have reported fourth-quarter earnings. Results have beaten expectations by the smallest margin on average since 2013. The disparity in developed market (DM) results was notable: Company results and analyst estimates point to earnings per share (EPS) for the U.S. S&P 500 growing 15% year-over-year, and EPS for Japan's TOPIX declining 5%. Post-earnings day price action showed cyclical's results (with autos a notable exception) were better received than those for defensives.
- European data disappointed. December German industrial production and manufacturing orders unexpectedly fell month-over-month. The UK services PMI fell to its lowest level since July 2016. The European Commission cut its 2019 euro area growth forecast to 1.3% from 1.9%. The Bank of England maintained rates but lowered its growth forecast to 1.2% from 1.7%.
- The USD strengthened, while global equities fell and bonds rallied. Information technology was the top-performing global sector. Central banks in India and Australia surprised with dovish policy stances.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	0.1%	8.2%	7.0%	2.1%
U.S. Small Caps	0.3%	11.8%	4.3%	1.7%
Non-U.S. World	-1.3%	6.1%	-7.3%	3.3%
Non-U.S. Developed	-1.4%	5.1%	-7.8%	3.5%
Japan	-2.1%	3.1%	-10.5%	2.5%
Emerging	-1.3%	7.3%	-8.4%	2.8%
Asia ex-Japan	-0.4%	7.0%	-7.9%	2.6%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-1.0%	15.4%	-4.2%	\$ 62.10
Gold	-0.3%	2.4%	-0.4%	\$ 1,314
Copper	1.2%	4.1%	-9.3%	\$ 6,210

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.4%	0.6%	3.6%	2.6%
U.S. TIPS	0.0%	1.2%	1.9%	2.8%
U.S. Investment Grade	0.5%	2.7%	2.3%	3.9%
U.S. High Yield	0.2%	4.8%	3.2%	6.9%
U.S. Municipals	0.3%	1.0%	3.8%	2.6%
Non-U.S. Developed	-0.7%	0.9%	-2.8%	0.9%
EM \$ Bonds	0.0%	4.5%	1.7%	6.3%

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.1%	-1.2%	-7.5%	1.13
USD/JPY	0.2%	0.1%	0.9%	109.74
Pound/USD	-1.1%	1.5%	-6.9%	1.29

Source: Thomson Reuters. As of Feb. 8, 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. dollars 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. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

Feb. 11 UK GDP

Feb. 14

China balance of trade; Japan GDP; eurozone GDP; U.S. Producer Price Index (PPI), retail sales, business inventories; UK Parliament Brexit vote scheduled

Feb. 12 OPEC Monthly Oil Market Report

Feb. 15

China CPI, PPI; U.S. new temporary budget expires, industrial production, capacity utilization

Feb. 13 IEA Oil Market Report; eurozone industrial production; U.S. Consumer Price Index (CPI)

Mid-Feb.

A delegation of U.S. officials could travel to China for the next round of trade talks

Talks between U.S. and Chinese trade officials this week are crucial ahead of a scheduled increase in U.S. tariffs on Chinese goods in early March. We could see a temporary deal but believe a full conflict resolution is unlikely. Market attention to global trade tensions has flagged recently, our [BlackRock geopolitical risk dashboard](#) shows, meaning that the potential market impact of this risk has likely risen.

Asset class views

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

	Asset class	View	Comments
Equities	U.S.	▲	Solid corporate earnings and ongoing economic expansion underpin our positive view. We have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see solid corporate fundamentals and cheap valuations as supportive, but the market lacks a clear catalyst for sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, coupled with a backdrop of economic reforms and policy stimulus, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though much has been priced in. 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 see most value in intermediate maturities, even with 10-year rates likely to remain in a tight trading range near term. A negative correlation with risk assets makes Treasuries attractive portfolio diversifiers. We see modestly soft economic news, positive fixed income flows and a first-half pause in Fed rate hikes as supportive. The impact of Fed balance sheet reduction should be muted.
	U.S. municipals	—	Strong front-end demand has pushed yields down while bonds with 10-year and longer maturities have been range bound. We prefer long-intermediate maturities for their attractive carry amid a steeper yield curve. Quarter-end is likely to bring typical tax-season selling.
	U.S. credit	—	Solid fundamentals are supportive, but late-cycle economic concerns pose a risk to valuations. We favor BBB-rated bonds in the investment grade space and emphasize credit selection. We see generally healthy fundamentals and supportive supply-demand and valuations in high yield, and prefer bonds over loans.
	European sovereigns	▼	Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials make European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect some concern about fundamentals and politics, and upcoming European elections are further potential risk catalysts.
	European credit	—	We remain cautious on investment grade credit but see attractive relative value and carry potential in the BBB segment. We are positive on European high yield and note significantly wider spreads versus the U.S. market. Yields appear lower on first glance but compare favorably when hedged back to the U.S. dollar.
	EM debt	—	Valuations remain attractive despite the recent rally, and limited issuance in recent months is supportive. A pause in U.S. monetary policy tightening and U.S. dollar strength removes a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
	Asia fixed income	—	We have low conviction on local currencies, though easing U.S.-China trade tensions would increase the appeal of the Chinese yuan. A focus on quality and fundamentals are prudent in credit, where we favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia and in Chinese real estate.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "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. BIIM0219U-742444-3/4

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