



WEEKLY COMMENTARY • AUG. 19, 2019

Key points

- 1 We do not view the inversion of the yield curve as a recessionary signal, and see central banks' dovish pivot stretching the growth cycle.
- 2 The U.S. delayed imposing tariffs on some Chinese imports. Political turmoil engulfed Hong Kong, Italy and Argentina.
- 3 Central bankers are meeting in Jackson Hole, Wyoming this week as the effectiveness of their monetary policy tool kits has come under question.

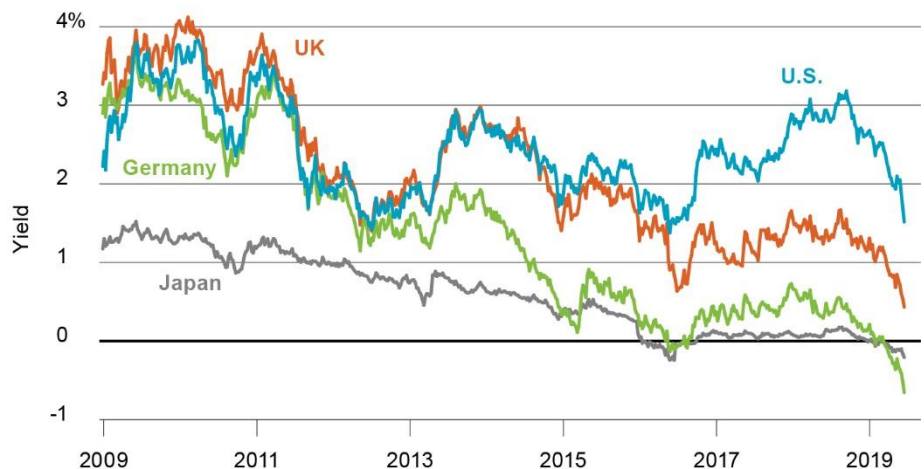
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1 Look beyond market selloffs

The “risk-off” mood in global markets deepened last week – as global government bond yields plunged to historical lows and the inversion of part of the U.S. Treasury curve sparked recession fears. Perceived safe-haven assets such as gold rallied. We still see limited near-term recession risks as central banks' dovish pivot helps stretch the economic cycle, yet caution that trade and geopolitical tensions pose downside risks.

Chart of the week

Ten-year government bond yields, 2009-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, August 2019. Notes: The data are based on the 10-year government bond yields of the U.S., UK, Germany and Japan from July 1, 2009.

A resurgence in geopolitical tensions – a key theme of our [Midyear 2019 Global Investment Outlook](#) – has raised concerns about downside risks to the economic outlook. These have been reflected in a selloff in equities and a rally in prices of developed market (DM) government bonds (corresponding to a decline in their yields). U.S. 10-year Treasury yields have dropped to the lowest level in three years. German 10-year government bond yields hit all-time lows, deeper in the negative territory. See the chart above. Yields on longer-maturity bonds also declined, with 30-year yields plunging to record lows in the U.S., UK, Germany and Switzerland. A U.S. Treasury yield curve inversion – with two-year yields now exceeding their 10-year counterparts – further spooked markets. Such inversions in the past have often foreshadowed recessions, but we believe the signaling power of the yield curve has diminished amid changing market dynamics.



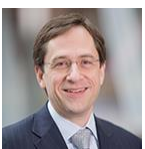
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Examining market dynamics

The European Central Bank (ECB)'s aggressive dovish pivot, a surge in short-dated Treasuries issuance and heavy buying of longer-dated Treasuries from institutions such as pension funds have all contributed to a flattening yield curve. A collapse in the term premium – or the excess yield investors demand for holding longer maturities – and a global savings glut have also pushed down long-term interest rates. As a result, we caution against using the flattening yield curve in isolation as a signal. To be sure: We did [downgrade our growth outlook](#), as trade and geopolitical frictions are stoking greater macro uncertainty. Yet we see little near-term risk of U.S. recession. One sign of still resilient economic fundamentals: [Financial conditions](#) in the U.S., eurozone and Japan remain accommodative, even after having tightened noticeably over the last few weeks due to intensifying U.S.-China tensions.

We are moderately constructive on equities, with the expansion intact and valuations still reasonable. [Our research](#) also shows equities have historically performed well in late-cycle periods. Yet geopolitical tensions are likely to trigger bouts of significant volatility. The market is vulnerable to sentiment swings: The bulk of global equity market returns this year has been driven by multiple expansion, rather than earnings growth. The resilience of U.S. corporate earnings in the first half of 2019 underlines our preference to U.S. equities. Earnings were roughly in line with year-ago levels, and surprised to the upside, albeit against sharply lowered expectations. This is no small feat, as early-2018 earnings were boosted by tax cuts. European corporates are expected in aggregate to post earnings declines for the second quarter – but not as steep as in the first quarter. We are neutral on European stocks.

Bottom line: Government bonds have served their role as portfolio ballast during risk-off bouts, reinforcing our call for greater portfolio resilience. We are neutral on government bonds overall, but on a tactical basis we are underweight U.S. Treasuries. We see market expectations of aggressive Federal Reserve easing as excessive and inflation risks as underappreciated. We like min-vol as an equity style factor. It has historically tended to perform well during economic slowdowns – and has held up well during the latest risk selloff.

2 Week in review

- The U.S. decided to delay imposing tariffs on some Chinese imports to Dec. 15 from Sept 1. U.S. stocks rebounded sharply on the news, but posted losses for a third straight week.
- An escalation of civil unrest in Hong Kong forced cancellations of flights in and out of the city's airport, one of the busiest in the world. Italy's Senate postponed further debate on a no-confidence vote till next week. Argentina's opposition leader Alberto Fernandez unexpectedly beat President Mauricio Macri in a primary election.
- German's ZEW survey suggested elevated concerns over the health of the economy, which contracted in the second quarter as expected. China posted its slowest industrial output growth in more than 17 years. Fixed asset investment and retail sales also disappointed.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-0.9%	16.7%	3.8%	2.0%
U.S. Small Caps	-1.2%	11.7%	-10.1%	1.8%
Non-U.S. World	-1.3%	7.3%	-2.2%	3.4%
Non-U.S. Developed	-1.4%	8.2%	-2.4%	3.5%
Japan	-1.9%	4.9%	-4.8%	2.6%
Emerging	-1.0%	2.6%	-2.2%	3.1%
Asia ex-Japan	0.1%	2.8%	-3.6%	2.7%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	0.2%	9.0%	-17.9%	\$58.64
Gold	1.1%	18.0%	29.0%	\$1,514
Copper	-0.2%	-3.7%	-3.3%	\$5,744

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	1.3%	8.5%	10.4%	1.5%
U.S. TIPS	0.6%	8.6%	7.3%	1.7%
U.S. Investment Grade	1.2%	13.3%	12.8%	2.9%
U.S. High Yield	-0.2%	9.7%	5.8%	6.1%
U.S. Municipals	0.5%	7.6%	8.8%	1.6%
Non-U.S. Developed	0.2%	6.0%	7.0%	0.4%
EM \$ Bonds	-0.7%	12.7%	13.0%	5.3%

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.0%	-3.3%	-2.5%	1.11
USD/Yen	0.7%	-2.9%	-4.1%	106.38
Pound/USD	0.9%	-4.8%	-4.5%	1.22

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Refinitiv Datastream. As Aug. 16, 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

Aug 21

Federal Open Market Committee meeting minutes

Aug 22-24

Annual central bankers' Jackson Hole meeting

Aug 22

ECB monetary policy meeting minutes; eurozone composite purchasing managers' index (PMI)

Aug 24-26

G7 meeting

The annual gathering of central bankers in Jackson Hole, Wyoming takes place at a time when the effectiveness of policy makers' toolkits is under question. How will they fight the next downturn against a backdrop of rates falling to zero or below? Fiscal policy on its own will likely struggle to provide major stimulus in a timely fashion given high debt levels. Without a clear framework in place, policymakers will inevitably find themselves blurring the boundaries between fiscal and monetary policies, running the risk of damaging their hard-won credibility. Our new [Macro and market perspectives](#) outline the contours of a framework to mitigate such risks.

Asset class views

Views from a U.S. dollar perspective over a three-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, which has 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 have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply-demand dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	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	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver – or even exceed – stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. 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 have upgraded EM bonds to overweight on 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 believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities in Latin America and in countries not directly exposed to U.S.-China trade 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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