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## Key points

1 A dovish pivot by global central banks should extend the length of this economic cycle, supporting our upgrade to emerging market (EM) debt.

2 Remarks last week from the chair of the Federal Reserve appeared to signal an imminent rate cut, providing more evidence of this dovish shift.

3 Second-quarter earnings season begins this week, with S&P 500 firms expected to post the first quarter of negative earnings growth since 2016.

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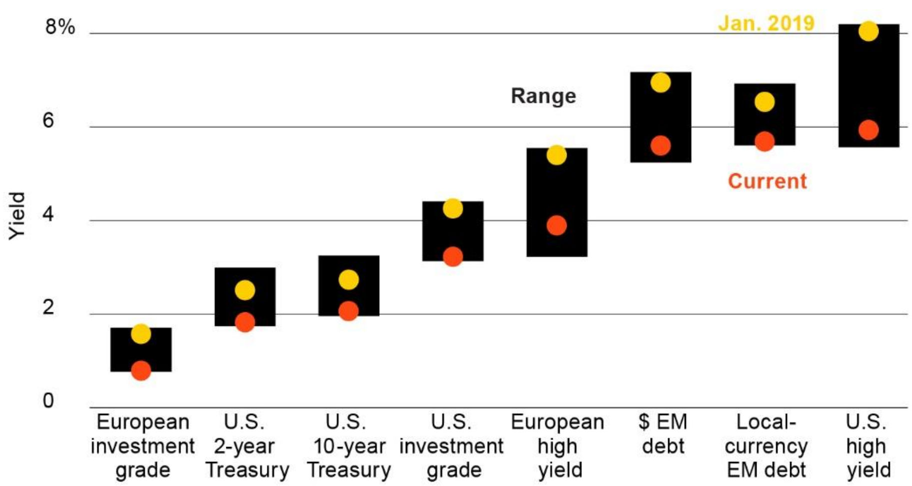
## 1 Seeking income in emerging market debt

Central banks are shifting toward monetary easing, as they aim to cushion a global slowdown sparked by trade tensions. This policy pivot should help stretch the cycle and has depressed long-term yields, creating a supportive backdrop for income-generating assets. One such asset we favor: local-currency EM debt.

### Chart of the week

Yield ranges on various fixed income asset classes, 2018-2019




**Past performance is not a reliable indicator of current or future results.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, Bloomberg Barclays and J.P. Morgan, July 2019. Notes: The black bars show the range in yields for each index from the start of January 2018. The dots show the yields now and in January 2019. Indices used: Bloomberg Barclays Pan-European Corporate, Refinitiv 2-year and 10-year benchmark U.S. Treasury, Bloomberg Barclays U.S. Corporate Investment Grade, Bloomberg Barclays Pan-European Corporate High Yield, J.P. Morgan Emerging Market Bond Index Global Diversified, J.P. Morgan Government Bond Index-Emerging Markets Global Diversified and Bloomberg Barclays U.S. Corporate High Yield. It is not possible to invest directly in an index.

The decisively dovish turn in global monetary policy this year has helped drive bond yields to the bottom of recent ranges. See the dots in the chart above. We expect low rates to persist, with the Fed poised to deliver an insurance rate cut soon and the European Central Bank likely to provide additional stimulus by the end of October, opening the door for further global monetary easing. We see coupon income as the key driver of bond market returns in this lower-for-longer environment. Against this backdrop, we upgraded EM bonds to overweight in our 2019 midyear Global investment outlook.

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## The case for local-currency markets

EM debt comes in two flavors: bonds denominated in the issuer's local currency and bonds denominated in another currency such as the U.S. dollar, so-called hard-currency debt. Global central banks' dovish shift has spurred both types of EM debt to rally, mostly driven by declining global rates. To be sure, the U.S. Treasury rally may have gone a little too far: We see markets pricing in too much Fed easing given still decent economic fundamentals. Yield increases would dampen our expectations for further price gains in U.S. dollar EM debt. Yet we see reasons to be bullish on selected local-currency EM debt, where we believe the rally still has room to run.

Sharp appreciations in the U.S. dollar – and their potential to tighten financial conditions – have historically posed the greatest risk to EM assets. Yet we see a relatively stable dollar ahead. This reduces the risk of investing in local-currency denominated EM debt. Other positives: We expect China's growth to be broadly stable, with policymakers ready to offset the economic drag from any trade shocks with additional fiscal stimulus – even though we do not expect a meaningful Chinese growth boost. Consumption remains resilient in many EM economies, despite a global manufacturing slowdown. And we see scope for central banks in many EMs – from India to Brazil – to lower interest rates, leading to further compression in local yields. Risks to our view include a greater-than-expected rise in U.S. Treasury yields, and tensions between the U.S. and China escalating or broadening to the Americas, Europe or other Asian economies, hurting EM manufacturing sectors.

We prefer a selective approach to local-currency debt, favoring longer-term debt in Brazil, Mexico, India and Indonesia. These markets have relatively low exposure to U.S.-China trade tensions and yields that compensate for risks. More positives: high real yields, potential for monetary policy easing, strong external positions (small current account deficits and more foreign assets than liabilities) and sound institutions. We expect strategic tensions between the U.S. and China to persist, even if we see a temporary trade truce. The greater market weight of countries with high China exposure in EM equity indexes partly explains our more cautious view on EM stocks.

## 2 Week in review

- Fed Chair Jerome Powell's remarks before Congress and minutes from the FOMC's June meeting set the stage for an imminent rate cut by the central bank, providing more evidence of a dovish shift in monetary policy that we see stretching the cycle and supporting risk assets (one of the three key themes in our 2019 midyear Global investment outlook). Powell stated that despite recent strength in some U.S. economic data, uncertainty from slower global growth, persistently low inflation and trade developments weigh on the Fed's outlook. The FOMC minutes said "many" Fed participants indicated "the case for somewhat more accommodative policy had strengthened." U.S. stocks hit new highs on expectations for Fed easing.

- U.S. Treasury yields rose after the U.S. core Consumer Price Index came in higher than expected, at 0.29% month-over-month, the largest gain since January 2018. We do see the Fed likely cutting rates as insurance against escalating trade conflicts, but believe markets may be counting on too many Fed rate cuts given that we see little near-term risk of recession. The Bank of Canada held rates steady amid rising trade tensions but noted data show the Canadian economy is returning to potential growth.

### Global snapshot

Weekly and 12-month performance of selected assets

| Equities | Week | YTD | 12 Months | Div. Yield |
|---|---|---|---|---|
| **U.S. Large Caps** | 0.8% | 21.5% | 9.9% | 1.9% |
| **U.S. Small Caps** | -0.3% | 17.3% | -5.8% | 1.7% |
| **Non-U.S. World** | -0.6% | 14.0% | 1.3% | 3.2% |
| **Non-U.S. Developed** | -0.5% | 14.5% | 1.2% | 3.4% |
| **Japan** | -0.4% | 9.3% | -0.4% | 2.5% |
| **Emerging** | -0.7% | 10.7% | 1.0% | 2.8% |
| **Asia ex-Japan** | -1.1% | 10.4% | -0.4% | 2.6% |

| Bonds | Week | YTD | 12 Months | Yield |
|---|---|---|---|---|
| **U.S. Treasuries** | -0.3% | 4.6% | 6.5% | 2.1% |
| **U.S. TIPS** | 0.2% | 6.2% | 4.7% | 2.2% |
| **U.S. Investment Grade** | -0.4% | 9.4% | 9.4% | 3.2% |
| **U.S. High Yield** | -0.1% | 10.2% | 7.2% | 5.9% |
| **U.S. Municipals** | 0.3% | 5.5% | 6.8% | 2.0% |
| **Non-U.S. Developed** | -0.2% | 4.1% | 3.5% | 0.6% |
| **EM $ Bonds** | -0.4% | 11.6% | 10.7% | 5.5% |

| Commodities | Week | YTD | 12 Months | Level |
|---|---|---|---|---|
| **Brent Crude Oil** | 3.9% | 24.0% | -10.4% | $ 66.72 |
| **Gold** | 1.1% | 10.4% | 13.5% | $ 1,416 |
| **Copper** | 0.6% | -0.5% | -4.7% | $ 5,935 |

| Currencies | Week | YTD | 12 Months | Level |
|---|---|---|---|---|
| **Euro/USD** | 0.4% | -1.7% | -3.4% | 1.13 |
| **USD/Yen** | -0.5% | -1.5% | -4.1% | 107.91 |
| **Pound/USD** | 0.4% | -1.4% | -4.8% | 1.26 |

**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 July 12, 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

| | | | |
|---|---|---|---|
| **July 15** | China gross domestic product (GDP), retail sales, industrial production, fixed asset investment; Second quarter (Q2) earnings season kicks off | **July 17** | U.S. Fed Beige Book |
| **July 16** | U.S. retail sales, industrial production; Germany ZEW Economic Sentiment Index | **July 19** | Japan CPI; U.S. consumer sentiment |

Several large banks kick off Q2 earnings season this week. Analysts expect S&P 500 companies on average to report lower earnings versus the year-earlier quarter. This would mark the first quarter of negative earnings growth since 2016, if results come in as expected. The first quarter of 2019 faced similar expectations, but companies ultimately eked out modestly positive earnings growth. Rising trade tensions pose a risk to Q2 results, but we expect company fundamentals to generally remain strong, particularly in the U.S. A number of industrial and materials firms have issued Q2 profit warnings recently, mostly within Europe.

## 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 momentum and min-vol, but have turned neutral on quality due to elevated valuations. |
| | 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 seethe 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. Investment-grade credit remains a 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. We generally favor credit for eurozone investors as income is key in region where many rates are negative. |
| | European credit | — | We have upgraded European credit to neutral. Fresh ECB policy should include corporate bond purchases. "Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to U.S. counterparts. |
| | 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 outside Asia, such as in Latin America, 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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