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Weekly commentary

BlackRock

Oct. 28, 2019

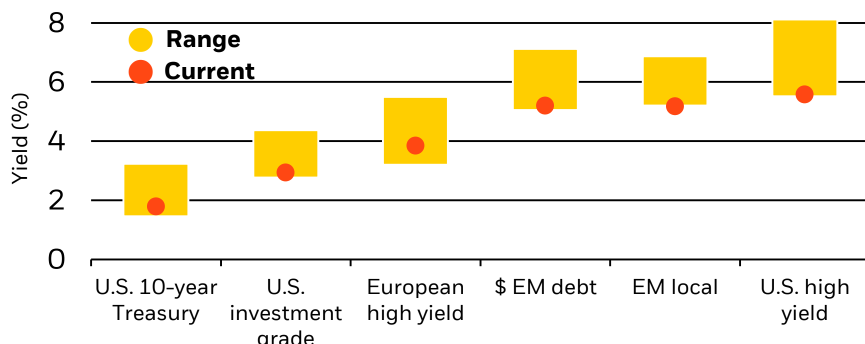
Reaffirming our EM views after a rally

- Emerging market (EM) debt has rallied amid a perceived easing of U.S.-China trade tensions. We reiterate our EM views after this uptick.
- Chinese growth is slowing as both structural changes and the trade conflict serve as a drag. But we see some signs of stabilization.
- We expect the Federal Reserve will cut rates this week and possibly once next year, as insurance against a broad economic slowdown.

One beneficiary of a perceived easing in the U.S.-China trade conflict: EM debt, which has rallied recently and outperformed developed market peers. We see factors further supporting EM debt from here: a likely Fed rate cut this week and the potential for a stable U.S. dollar; an EM growth rebound; and a temporary U.S.-China trade truce. We favor selected EM debt for its income potential. Yet likely twists and turns on trade talks in the near term keep us neutral on EM equities, which have greater exposure to China.

Chart of the week

Selected fixed income yields, 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, October 2019. Notes: The bars show the range in yields for each index from the start of January 2018. Indices used: Refinitiv 10-year benchmark U.S. Treasury, Bloomberg Barclays U.S. Corporate Investment Grade, Bloomberg Barclays Pan-European Corporate High Yield, J.P. Morgan Government Bond Index-Emerging Markets Index, J.P. Morgan EMBI Global Diversified Index and Bloomberg Barclays U.S. Corporate High Yield Index. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index.

Fixed income yields generally remain near the bottom of their historical ranges, as global central banks' dovish pivot has sent rates lower and bond prices higher. The chart shows how this is especially true of EM debt yields, which have fallen amid declining core government bond yields and tightening yield spreads. See the positions of the dots in the bars above. So far this year, both hard currency EM bonds – those mainly denominated in U.S. dollars – and their counterparts denominated in local EM currencies (so-called local currency bonds) have delivered strong returns. Hard currency has outperformed mainly due to U.S. Treasuries' strong performance. Despite this outperformance, we favor local-currency markets. We see them having more room to run for the remainder of 2019, given our outlook for a range-bound U.S. dollar and the potential for monetary easing in many EMs amid benign inflation.

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The Fed's dovish shift has helped local EM currencies recover versus the U.S. dollar, and this may persist in the near term. We see the Fed cutting rates this week and possibly again next year, as it seeks to provide insurance against a broad economic slowdown. Its recent injections of liquidity into money markets have also helped weaken the dollar and hold down rates, in our view. Other factors behind our positive view of local currency markets remain intact too. A manufacturing slowdown is weighing on EM growth, but the consumer side of the global economy has so far largely remained resilient. And we see limited risk of a meaningful slowdown or recession in the EM world – a scenario that would potentially send EM currencies lower; the International Monetary Fund expects EMs to drive a global growth recovery in 2020. We also see space for further central bank rate cuts in a number of EM countries, including in Indonesia, India, Brazil and Mexico, not least because EM inflation pressures appear to be skewed to the downside.

Within EM local currency debt, we prefer exposures in countries not linked to China, where growth could decelerate further amid ongoing trade tensions. We see opportunities in Latin America, such as in Brazil and Mexico, and in countries not directly exposed to U.S.-China tensions, such as India. We are neutral EM equities overall, given our cautious view of the China-related countries that constitute a big part of the EM index. We see the elevated global trade tensions arising from the *protectionist push* remaining a major driver of economic activity and financial markets going forward (see our recent Weekly commentary and our Q4 outlook update). Our research shows that significant increases in trade uncertainty have historically led to risk-off events for equities and caused elevated demand for developed market sovereign bonds. Trade uncertainty affects most Asian economies to a greater extent since they are more heavily exposed to China, we find.

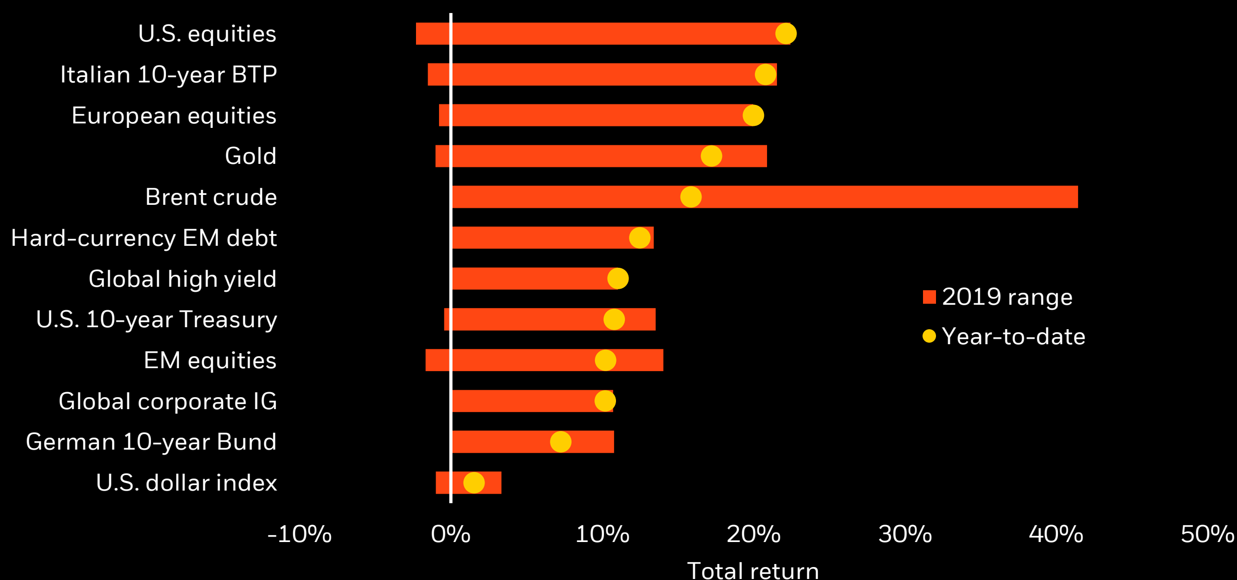
There are risks to our EM views. These include a significantly stronger U.S. dollar, which is not our base case. We see the dollar likely remaining range bound into 2020. Yet we see some risk of dollar appreciation later in 2020 as market expectations for Fed easing still appear excessive to us. Geopolitical hot spots are an ongoing risk to EMs. So far there has been little contagion to broader EMs from conflicts in Turkey and the Middle East and an economic crisis in Argentina, but that could quickly change depending on how these scenarios unfold (see our Geopolitical risk dashboard).

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.

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Macro insights

Chinese growth is slowing as both structural changes – such as efforts to cap debt levels – and the trade conflict serve as a drag. But we see some signs of stabilization. China's GDP rose 6% year on year in the third quarter, below market expectations. Yet that masked an uptick in industrial production, retail sales, and construction data in September, suggesting growth could be steady for the rest of the year. Our Growth GPS for China has ticked higher and suggests steady near-term growth, if at levels more subdued than those of the past two years. Beijing's attempts to restrain the property market are likely to weigh on activity. And we do not see a repeat of the aggressive policy stimulus implemented between 2015 and 2017 that pushed annual growth rates closer to 7%. The government appears to be prioritizing growth sustainability while debt levels remain elevated. Accelerating consumer inflation also reduces the likelihood of easier monetary policy.

Signs of stabilization

China Growth GPS and Caixin Composite PMI, 2015-2019

Sources: BlackRock Investment Institute and Markit, October 2019. Notes: The GPS (orange line) shows where the Caixin composite PMI may stand in three months' time. The green line shows the current PMI level. Forward-looking estimates may not come to pass.

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. We see the most likely outcome to be a general election in the UK in coming months, and ultimately for a new deal to pass in Parliament.
- 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. 30 – The Fed will hold its penultimate monetary policy meeting for the year, with markets pricing in a rate cut. We expect the Fed will cut rates this week and possibly again next year, as insurance against a manufacturing slump leading to a broader economic slowdown. However, market expectations for 2020 rate cuts look excessive to us. We see a pickup in global growth in the next 6 to 12 months, as policy stimulus gradually filters through to the real economy.

Oct. 29 – Nov. 1 – U.S. economic data – including consumer confidence, GDP and non-farm payrolls data – are likely to provide more signs that a resilient consumer is helping to support the U.S. economy amid a manufacturing slowdown.

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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