Weekly commentary

Nov. 18, 2019

BlackRock

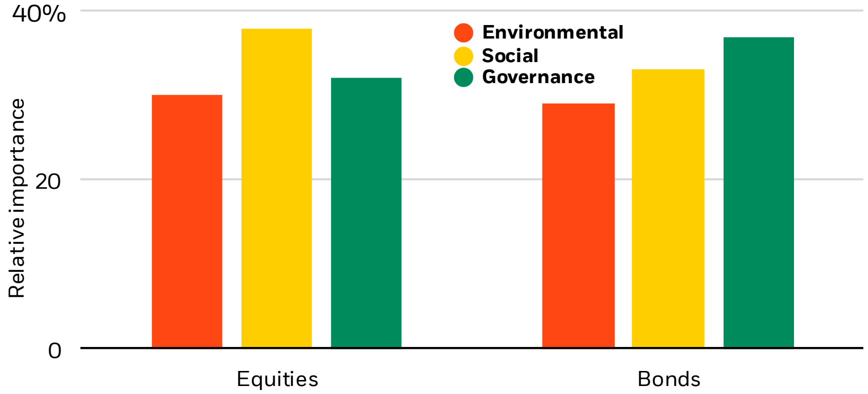
Getting sustainable in fixed income

- The equity market has played an early role in sustainable investing, but fixed income is catching up, thanks to new data, tools and insights.
- We see growth stabilizing but are watching for signs of manufacturing weakness spilling over while central banks likely hold the line.
- Markets will focus on this week's purchasing managers' index (PMI) data across the euro area and the U.S. for signs of stabilizing growth.

The equity market has played an early role in sustainable investing, while bond markets have lagged in data, tools and insights. But that's changing fast, as we detail in a new publication: *Sustainability: the bond that endures*. New ESG indexes have created building blocks that can be used to bring sustainability into the core of portfolios, even in asset classes such as emerging market (EM) debt that until recently lacked sustainable solutions.

Chart of the week

Financial materiality of E, S and G in equities and credit, 2015-2019



Source: BlackRock Investment Institute, with data from MSCI, Sustainalytics and Refinitiv, October 2019. Notes: The chart shows BlackRock's estimate of the financial materiality (or relative importance, in percentage terms) of E, S and G factors in driving performance in global equities and credit market over January 2015 through June 2019. We use regression analysis to estimate the relationship between each ESG pillar and monthly excess returns over the period. Equities analysis is based on the MSCI World Developed index. Bonds are based on credit spread returns of the Bloomberg Barclays Global Aggregate credit index. For illustrative purposes only.

Sustainable investing is the combination of traditional investment approaches with environmental, social and governance (ESG) insights. The "E" includes climate risks, "S" covers labor issues and product liability risks, and "G" refers to topics such as corporate board quality and effectiveness. What ESG factors really move the dial in financial performance? Organizations such as the Sustainability Accounting Standards Board (SASB) have taken the lead in investigating which sustainability topics are most relevant across industries. Our quantitative work builds on such studies, extending the analysis to global equities and credit. A key conclusion: Market pricing suggests each of the three ESG pillars are of roughly similar levels of importance in both credit and equity markets, as the chart shows.

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BlackRock **Investment** Institute

The need for sustainable fixed income solutions is growing: Bonds are in high demand – against a backdrop of aging populations in search of income and geopolitical volatility that has sparked greater demand for "safe" assets. We believe fixed income investors can draw on many of the insights that equity-focused research has produced on ESG. Companies or issuers with strong ESG performance are likely to be better at managing operational and reputational risks. Yet there are nuances to sustainable investing in bonds. Sovereign debt requires a different approach, as we detail in *Sustainability: the bond that endures*. And in contrast to equities, fixed income investors' main focus is often on mitigating downside risk, rather than capturing upside potential. We believe ESG metrics can help identify new risk factors.

The materiality of each of the ESG pillars varies across industries. Take financials. The "E" pillar appears to have more sway on market pricing than commonly thought. We found a meaningful link between returns on banks' corporate debt and "E" factors such as low carbon transition. Why is this the case even though bank operations have little direct exposure to environmental factors? Bank loans to fossil fuel producers may be at risk of future losses in a scenario in which carbon taxes are introduced, for example. We believe such analysis on an industry level can help inform investment decisions. Investors may want to consider tilting toward (or away from) ESG exposures that are most financially relevant in each industry, for example. Drilling deeper on ESG metrics – and utilizing new data sources – can also inform risk management. Previous work we have done shows that "E" factors, such as extreme weather, pose tangible risks to long dated assets – from electric utilities and commercial real estate to municipal bonds. See *Getting physical: assessing climate risks* for more.

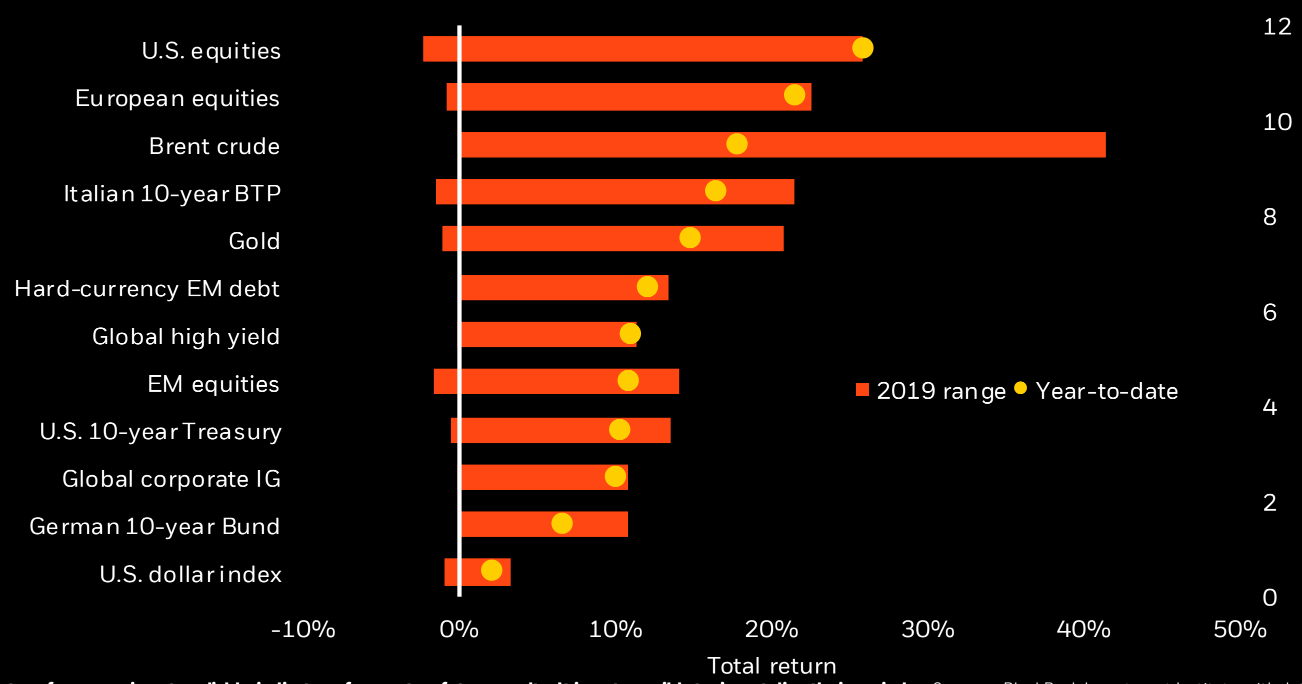
The *"why not?" moment* in sustainable investing has arrived in fixed income as well. Investors can now use sustainable building blocks to integrate sustainability across equities *and* fixed income allocations. Our analysis suggests that ESG indexes offer similar risk/return properties to traditional benchmarks, while adding a dose of portfolio resilience. See *Sustainability: the future of investing* for more. ESG-related risks such as the rising frequency and intensity of hurricanes are likely to compound over time. The flip side is potential opportunities in areas such as renewable energy. Bottom line: Investors now have the tools to integrate critical ESG factors in fixed income.

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 in part by loose financial conditions. See our macro data dashboard.

Assets in review

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



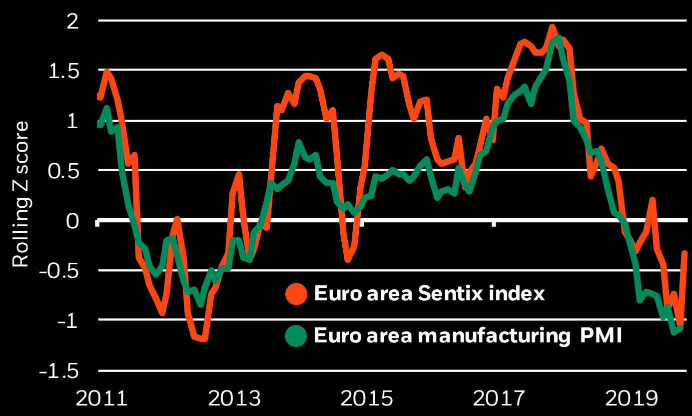
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end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

Macro insights

Euro area growth has deteriorated significantly over the past two years. Yet financial conditions are supportive and more recent data provide signs that the worst could be behind us. German factory orders for September surprised to the upside. Production for the same month declined, but the rise in orders suggests output may start to stabilize. And the Sentix investor confidence survey for November jumped. This is reassuring due to the loose connection between the Sentix and PMIs. Even if the incoming dataflow may be troughing, the growth outlook is unlikely to see a rapid turnaround. The European Commission downgraded its 2020 growth forecasts to 1.2% from 1.5% in May. Any improvements are likely to come from countries that suffered the most in this manufacturing and global trade-driven slowdown – Germany and Italy. A re-escalation of trade uncertainty poses downside risks to the outlook and the Commission forecasts suggest no major fiscal stimulus next year.

Searching for the bottom

Euro area PMI and Sentix index, 2011-2020



Sources: BlackRock Investment Institute, IHS Markit and Sentix, with data from Refinitiv Datastream, November 2019. Notes: the chart shows the euro area manufacturing PMI and the Sentix overall euro area investor confidence survey. We plot the data as an expanding Z-score – a way of avoiding sample bias in the data – starting in 2009. Z-scores normalize different data series as standard deviations relative to a mean.

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.
- The likelihood that a revised North American trade pact will be ratified this year looks to have risen, amid reports that Democratic lawmakers had made progress getting key priorities reflected in the deal.
- Yet 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.
- 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

- 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 in part to loose financial conditions. This should take the reins from monetary policy in supporting risky assets.
- **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

Nov. 22 – Markets will scrutinize the PMI data across the euro area and the U.S. for signs of stabilizing growth, particularly in the manufacturing sector. The global manufacturing sector has begun to show signs of bottoming out. We see global growth stabilizing thanks to a lull in trade tensions and easier financial conditions.

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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