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Weekly commentary

BlackRock.

Jan. 27, 2020

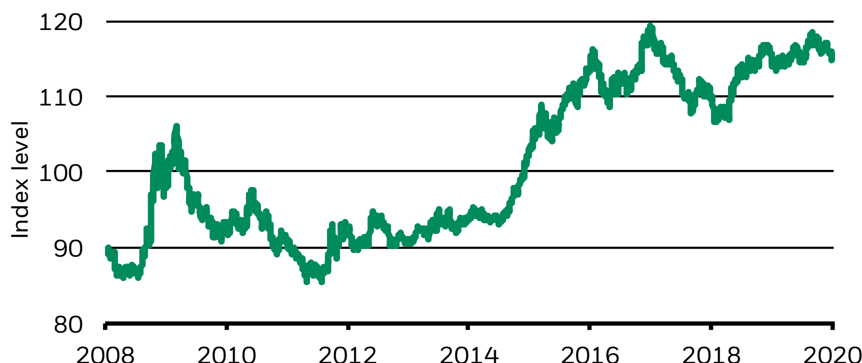
U.S. dollar underpins EM assets

- We see the U.S. dollar stabilizing or weakening in 2020 after a long run-up, supporting our preference for emerging market (EM) assets.
- We see global growth stabilizing and gradually edging up over the next six to 12 months, thanks in part to easy financial conditions.
- Markets are split on whether the Bank of England will cut rates this week – for the first time in four years, after mixed data in recent weeks.

We see the U.S. dollar stabilizing or weakening over the next six to 12 months. Two broad drivers – monetary policy differentials and risk appetite – decide the dollar's moves, in our view. We see a pause in monetary policy in most developed markets (DM) and some room for additional easing in EMs; easing trade tensions should underpin risk appetite, reducing "safe haven" demand for the dollar. Our currency view underpins our preference for local-currency EM debt and equities.

Chart of the week

Trade-weighted broad U.S. dollar index, 2008-2020



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 the Federal Reserve Bank of St. Louis, January 2020. Notes: The index represents a weighted average of the foreign exchange value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners.

Global trade tensions weighed on global growth and kept investors on edge in 2019. This coincided with a rally in the dollar to near post-crisis highs, as the chart above shows. The dollar, a perceived safe-haven asset, typically attracts interest when geopolitical risks flare up. With the U.S. and China signing a limited "Phase 1" trade deal and a revised North America trade pact passing the U.S. Congress, we see global trade tensions going sideways in 2020. This should support overall risk sentiment – and reduce flight-to-safety demand for the dollar. As a sign of reduced bullish bets on the dollar, speculators had cut their net long position on the currency to the smallest in 19 months as of Jan. 14, according to Reuters calculations and data from the U.S. Commodity Futures Trading Commission.

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Monetary policy (interest rate) differentials are a key driver for currency performance. The dollar was the highest-yielding developed market (DM) currency in early 2019 – on the back of the Federal Reserve's monetary policy tightening cycle. The Fed has since made a dovish shift and joined other DM central banks in taking a pause in monetary policy actions. This is likely to keep the dollar stable against other DM currencies, in our view. We also see reduced Brexit-related uncertainty as positive for European currencies, including the euro and British pound, removing some upward pressure on the dollar.

We expect global growth to edge higher this year and financial conditions to stay loose. This should provide support for most EM currencies, even as we see some room for EM central banks to further ease their monetary policy in 2020. Subdued market volatility makes "carry" strategies in the foreign exchange market (borrowing in lower-yielding currencies and buying higher-yielding ones) more attractive, adding to the appeal of EM currencies. We see the Chinese yuan stabilizing or slightly appreciating versus the dollar against the backdrop of a positive growth outlook and easing trade tensions. This could help support other EM Asian currencies such as the Indonesian rupiah. From a valuation perspective, currencies including the Russian ruble and Brazilian real appear cheaply valued after sharp selloffs in recent years. Appreciation in EM currencies has historically tended to contribute to positive returns in EM assets overall, our analysis shows. This underpins our preference for EM equities and local-currency debt.

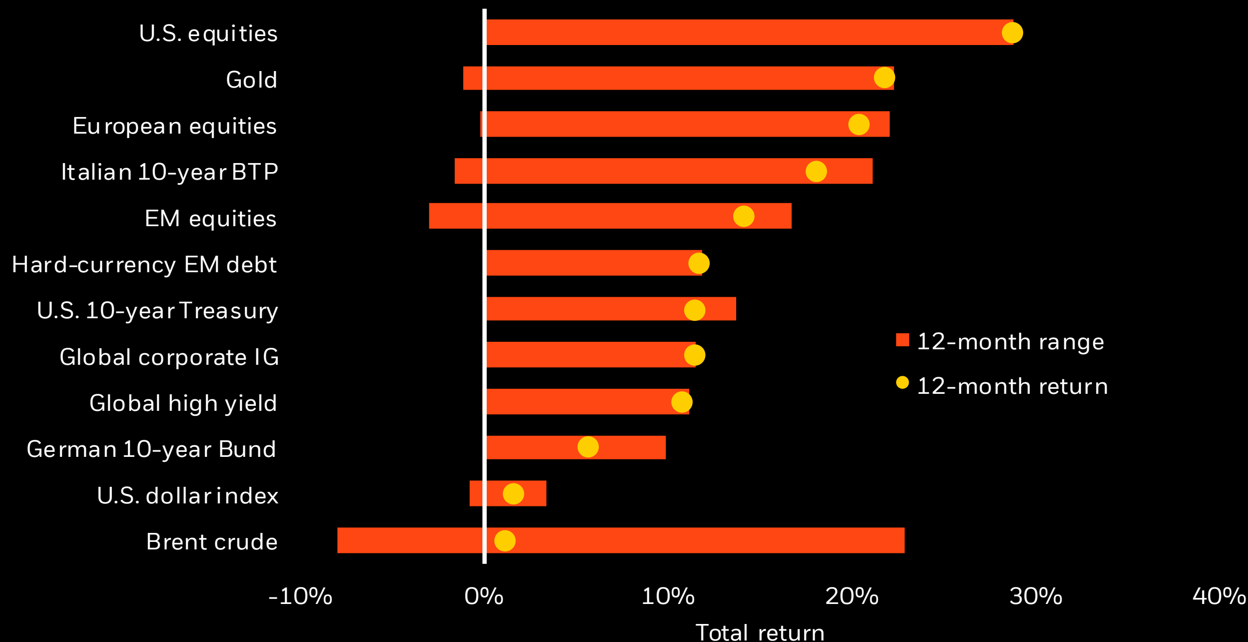
There are risks to our view on the U.S. dollar. Geopolitical risks could potentially flare up in a number of areas including trade disputes and Middle East tensions. Any sustained escalation in such risks could spark risk-off episodes and drive investors to perceived safe-haven assets including the dollar. See our latest analysis on our BlackRock Geopolitical Risk Dashboard. Another risk: the Fed sounding unexpectedly hawkish in 2020 due to surprisingly strong growth and inflation. Markets may be vulnerable to any such shocks: Low volatility across asset classes, including currencies, point to a risk of complacency.

Market backdrop

An upbeat start to the corporate results reporting season has helped propel equity markets to record highs, but worries about a virus outbreak in China and its potential economic impact weighed on sentiment. Abating trade tensions, signs of economic stabilization in China and still accommodative financial conditions also supported the risk-on sentiment. We are on the watch for more signs that global manufacturing may be bottoming out, as economic fundamentals are expected to pick up the baton to drive growth while the dovish pivot by major central banks has run its course for now. We see global growth edging up over the first half of 2020 as easier financial conditions start filtering through and a pause in trade disputes give global trade activity some breathing room.

Assets in review

Selected asset performance in the past 12 months



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, January 2020. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared to 12 months earlier. 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

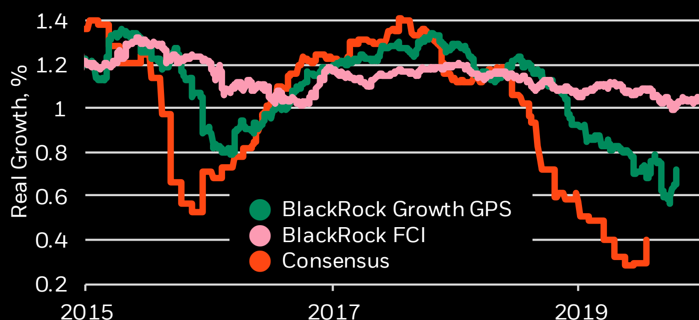
Abating global trade uncertainty, an uptick in activity for Japan's key trading partners, notably China, improving manufacturing sentiment and loose financial conditions have helped to brighten Japan's outlook.

The Bank of Japan upgraded its growth estimates last week. Our BlackRock Growth GPS for Japan and consensus expectations both appear to be bottoming out as the impact from the hike in the value-added tax implemented in the fourth quarter of 2019 fades. Financial conditions remain highly accommodative, as shown on the chart on the right.

An improving domestic economy and rebounding global activity underpin our constructive views on Japanese corporate fundamentals, particularly those that are most sensitive to cyclical upturns – which account for a considerable part of the Japanese economy.

Signs of a growth pick-up in Japan

Japan GDP growth estimates, 2015-2020



Sources: BlackRock Investment Institute, Consensus Economics and Bloomberg, January 2020. Notes: The FCI line shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS. The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. The consensus line shows the current 12-month economic consensus forecast, as measured by Consensus Economics. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass.

Investment themes

1 Growth edges up

- We see global economic growth edging higher as easier financial conditions start filtering through.
- The growth mix is shifting as the modest pickup is likely to be led by manufacturing, business spending and interest rate-sensitive sectors such as housing.
- We believe the U.S. and China have strong incentives to hit pause on their trade conflict across 2020, though there may be turbulence along the way. A limited "Phase 1" trade deal between the U.S. and China as well as a revised North American trade pact should allow global trading activity some breathing space.
- We see China's economy stabilizing but little appetite among its leadership for large-scale stimulus. Europe and emerging markets should see higher average growth rates as they recover from a weak 2019.
- **Market implication:** We maintain a moderate pro-risk stance and see potential for cyclical assets such as Japanese and EM assets to outperform tactically.

2 Policy pause

- We see economic fundamentals driving markets in 2020, and less scope for monetary easing and other policy surprises. The lagged effect of policy easing should start to filter through to economic activity.
- The Federal Reserve has reaffirmed that the bar for further policy easing is high — with no policy action barring a significant growth slowdown or an unwanted tightening in financial conditions.
- The policy debate is set to zoom in on a potential shift from monetary to fiscal stimulus.
- Any fiscal support in 2020 is likely to come from outside the U.S.: notably Europe and Japan, as well as EM ex-China. We see the U.S. presidential election overshadowing the U.S. fiscal policy debate in 2020.
- The bottom line: We see little chance of meaningful fiscal stimulus, but believe even modest shifts toward fiscal easing may have outsized market impact.
- **Market implication:** Income streams are crucial in a slow-growth, low-rate world. We like EM and high yield debt.

3 Rethinking resilience

- The dovish pivot in 2019 pushed bond yields in some developed markets near levels we consider to be their lower bounds. This implies less room for yields to fall during risk asset selloffs.
- A weakening or breakdown of the negative correlation between stocks and bonds could also undermine the portfolio ballast role of government bonds.
- A focus on sustainability can also help make portfolios more resilient, in our view, by reducing exposure to environmental, social and governance (ESG) risks.
- The U.S. killing of a top Iranian military leader in the Middle East marked an escalation in the U.S.-Iran conflict. The U.S. and Iran have stepped back from direct military confrontation. Attacks on energy infrastructure in the region or disruption in shipping would generate greater market impact, in our view. Generally, we believe markets are underestimating cyber risks. See our geopolitical risk dashboard.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and like inflation-protected securities against inflation risks.

Weeks ahead

Jan. 28	U.S. Consumer Confidence Index	**Jan. 30**	Bank of England rate decision
Jan. 28-29	Federal Open Market Committee policy meeting ends	**Jan. 31**	Euro area flash inflation, preliminary flash GDP; China official purchasing managers index (PMI)

Markets are split on whether the Bank of England will cut rates this week – for the first time in four years. A series of weak data at the end of 2019 amid heightened Brexit uncertainty prompted several members of the Monetary Policy Committee to signal a bias towards stimulus to reinforce the expansion. Yet more recent data have been stronger than expected.

Directional views

Tactical views on major global assets from a U.S. dollar perspective, December 2019

Asset	Underweight	Neutral	Overweight

Equities

We remain modestly overweight on global equities. With central bank easing and expansion in valuation multiples largely behind us, we expect a growth uptick to take over as a key support. Valuations still look reasonable. An uptick in global manufacturing and trade activity favors a tactical tilt into more cyclical exposures, including EM and Japanese equities.

Credit

We maintain a modest overweight in global credit. The income potential of EM debt — particularly local-currency — looks especially attractive. With the growth uptick picking up the baton in supporting risk assets, we also upgrade our view on global high yield after the asset class has cheapened. We see global investment grade debt as less attractive due to rich valuations.

Government bonds

We are overall neutral on global rates. Major central banks are likely to keep policy mostly on hold in the near term, even as growth and inflation firm somewhat. This tilts risks toward a steepening of the yield curve. We prefer shorter maturities in U.S. Treasuries as well as exposures to inflation-linked debt amid rising U.S. wage pressures and potential for supply shocks that could firm inflation beyond expectations.

Cash

We maintain our neutral position on cash for risk mitigation and are using some of it to support our view on government bonds. This is in line with our modest tilt to risk in portfolios. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

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Granular views

Tactical views on selected assets vs. broad global asset classes by level of conviction, December 2019

Change in view: Previous → New

	Asset	Underweight / Overweight	
Equities	United States		We have downgraded U.S. equities to neutral. Rising uncertainty around the 2020 election and a wide range of potential policy outcomes may weigh on sentiment and prevent a repeat of outperformance.
Equities	Euro area		We have downgraded European equities to underweight after a stretch of outperformance – and see greater upside in cyclical exposures elsewhere. Markets look to have fully priced in the ECB's easing.
Equities	Japan		We have upgraded Japanese equities. We see this market among those set to benefit most from a global manufacturing recovery and a lull in U.S.-China trade tensions.
Equities	Emerging markets		We have upgraded EM equities as beneficiaries from the global recovery. EM central banks outside of China are likely to stay on their easing paths, supporting growth and equity markets.
Equities	Asia ex-Japan		We have upgraded Asia ex-Japan equities to neutral amid prospects of a growth uptick. We see China's economy stabilizing but stimulus as capped. Disruptions in global trade pose downside risks.
Equities	Momentum		We have downgraded momentum to underweight as valuations appear stretched. The factor has underperformed most other style factors in the second half of 2019.
Equities	Value		We have upgraded value due to its pro-cyclical nature and a steepening yield curve. We see an attractive entry point after value has substantially underperformed other factors in recent years.
Equities	Minimum volatility		We have downgraded min-vol to neutral. The factor has historically performed well late in the cycle, but the growth uptick causes us to pull back. Valuations still appear expensive versus other factors.
Equities	Quality		We have upgraded quality. Valuations have modestly cheapened. The factor has been resilient in late-cycle periods and includes global firms that stand to benefit from improving trade activity.
Fixed Income	U.S. Treasuries		We have upgraded U.S. Treasuries, preferring the front end of the curve. This offers shelter from any curve steepening triggered by stronger growth and some insulation against risk asset selloffs.
Fixed Income	Treasury Inflation-Protected Securities		We like TIPS due to cheap valuations relative to current inflation levels – and potential for more price pressures due to wage pressures, an uptick in activity and longer-term deglobalization.
Fixed Income	German bunds		We have downgraded German government bonds. Prices already reflect the ECB's easy policy stance. And we see limited scope for monetary easing to take rates to even more negative levels.
Fixed Income	Euro area peripherals		We have downgraded euro area peripheral government bonds. We see yields and spreads as insufficient to compensate investors for underappreciated political risks in the region.
Fixed Income	Global investment grade		We have downgraded global investment grade credit. Valuations appear rich, and we see low coupon rates making the sector's income relatively unattractive on a risk-adjusted basis.
Fixed Income	Global high yield		We have upgraded global high yield, supported by stable monetary policy and the prospect of a growth inflection. Spread widening, especially in lower-rated cohorts, has offered an entry point.
Fixed Income	Emerging market – hard currency		We still like hard-currency EM debt against a backdrop of dovish EM central banks, an improving growth outlook and a stable to somewhat weaker U.S. dollar. We prefer the high-yielders.
Fixed Income	Emerging market – local currency		We have upgraded local-currency EM debt to a high-conviction overweight. Coupons look attractive, and EM currencies could appreciate as DM central banks stick to easy policies.
Fixed Income	Asia fixed income		We have upgraded Asia fixed income. Asian central banks have room to ease policy, and currency stability is a positive. Valuations have become richer, and we prefer up-in-quality exposures.

Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

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