Weekly commentary

BlackRock.

Feb. 3, 2020

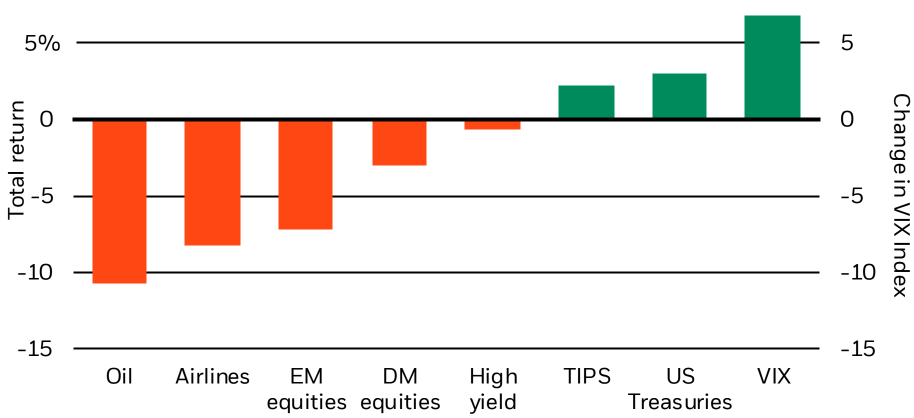
Coronavirus worry clouds markets

- The coronavirus outbreak has raised uncertainty around the global growth outlook, underlining our call for a focus on portfolio resilience.
- We see global growth stabilizing and gradually edging up over the next six to 12 months, thanks in part to easy financial conditions.
- We will look at the U.S. ISM purchasing managers' index data this week for evidence of a rebound in manufacturing activity in December.

The coronavirus outbreak emanating from China has sent jitters across financial markets amid fears of a hit to the global economy. We still expect growth to edge higher in 2020 thanks to easier financial conditions and trade tensions going sideways, yet the unknown magnitude and duration of the outbreak pose downside risks. This underpins our view that U.S. Treasuries provide a source of portfolio resilience.

Chart of the week

Market moves since Jan. 20, 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 Refinitiv, as of Jan. 31, 2020. Notes: On Jan. 20 the Chinese government confirmed the coronavirus could spread from person to person. TIPS refers to Treasury inflation-protected securities. The indexes used include the MSCI EM, MSCI World, Bank of America Merrill Lynch Global High Yield, S&P U.S. TIPS 10-year Index and Refinitiv Datastream 10-year US Government Benchmark indexes. Airlines are represented by the airlines industry in the MSCI World Index, and oil by Brent crude futures. The change in VIX Index refers to the change in percentage points in the CBOE Volatility Index.

The outbreak has sparked a classic risk-off response, albeit one of relatively modest magnitude to date. Emerging market equities, airlines and oil prices have declined since Jan. 20, when the Chinese government confirmed the virus can spread from person to person. Perceived safe-haven assets such as U.S. Treasuries, as well as their inflation-protected peers, have gained. See the chart above. The VIX index, a gauge of U.S. stock market volatility, shot up to the highest level since October. Yet the risk-off sentiment has so far been relatively limited, with modest pullbacks in high yield credit and U.S. stocks, even after Friday's sell-off. The impact from worries about the outbreak may have been partially offset by positive results in the current quarterly earnings season that so far are in line with our expectation for global growth to edge higher this year.

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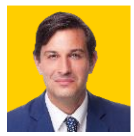

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BlackRock **Investment** Institute

What can we learn from past global disease outbreaks? Economic growth and markets have historically responded with a V-shaped pattern. The temporary hit to economic activity results in pent-up demand, which eventually helps fuel the rebound in economic activity. This recovery is typically led by retail and manufacturing sectors, since lost revenues are harder to recoup in the services sector (think of tourism).

It is too soon to gauge the impact of the current outbreak, given the many unknowns related to the coronavirus. These include the duration and severity of the outbreak in China – and whether it remains largely contained geographically. The reduced flow of people and goods due to travel restrictions and quarantine measures are likely to hit demand in the short term, pressuring economic activity in the most affected areas. The extent of the policy response by Chinese authorities to any growth slowdown is another key uncertainty. We are likely to see a meaningful policy response from Chinese authorities to shore up growth, as we have after prior epidemics, though an ongoing desire to rein in financial excesses leaves open the question of how sizable China's stimulus will be. Another potential difference from past episodes is China's increased role in the global economy: the country makes up 15% of global GDP today in purchasing parity terms. This is three times its size in 2003, when the world was hit by the SARS virus.

We also see potential supply side disruptions. China is now a key component of global supply chains. Any sustained outbreak could disrupt the supply chains of certain industries, with potential for bottlenecks. This risk echoes one of the messages of our 2020 Global Outlook – that investors should be on the lookout for potential shifts in the economic regime, such as a world in which growth slows as inflation creeps higher.

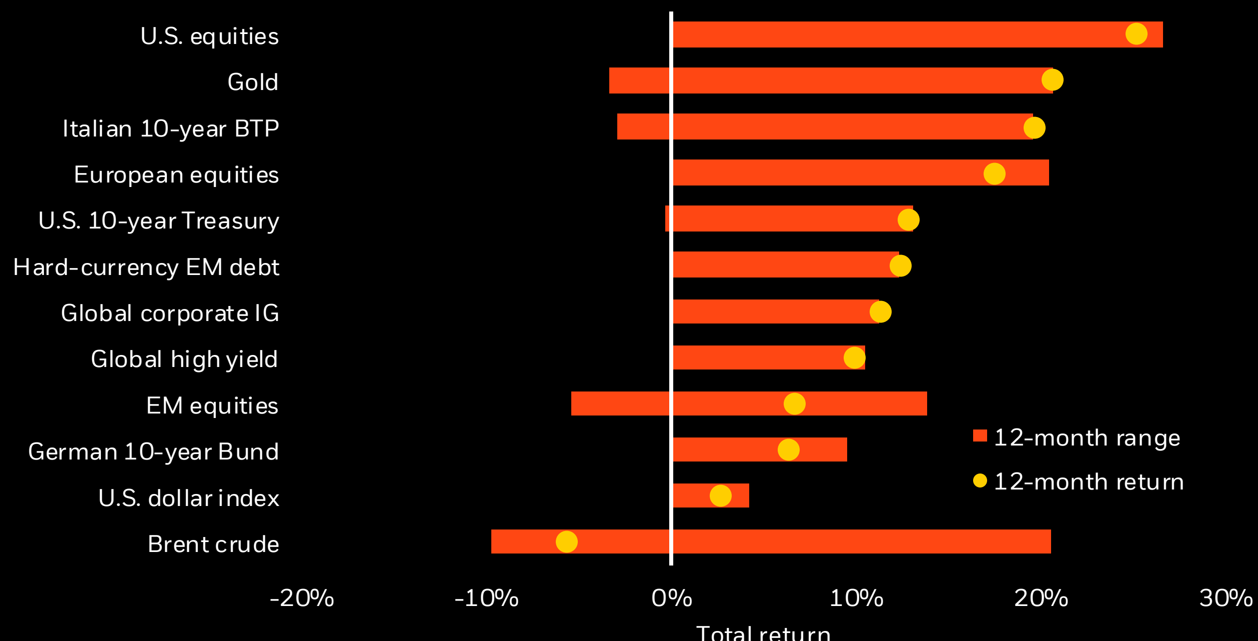
Bottom line: We still see global growth edging higher this year, given easier financial conditions, a lull in global trade tensions, and generally positive economic data. An encouraging start to the latest quarterly earnings season also underpins our moderate pro-risk stance. Yet the recent coronavirus outbreak creates downside risks to the growth outlook, and underscores our preference for U.S. Treasuries as a source of portfolio ballast against any growth scares.

Market backdrop

Positive corporate earnings have limited equity losses triggered by worries about the coronavirus outbreak in China and its potential economic impact. Moderating trade tensions, signs of economic stabilization and still accommodative financial conditions are supportive of growth. We are on the watch for more signs that global manufacturing may be bottoming out in next week's global PMIs. A pause in trade disputes give global trade activity some breathing room. The upcoming U.S. Democratic Party primaries are unlikely to produce a clear leading presidential candidate any time soon, underscoring rising political uncertainties.

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.

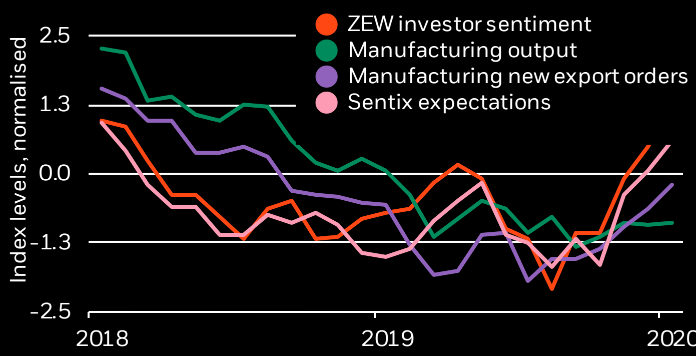
Macro insights

German manufacturing data in January suggested demand is firming up, shaking off the trade drag that nearly pulled the German economy into recession last year. Our German Growth GPS points to a slight acceleration over the next three months.

Signs of improvement were echoed by a slew of other indicators, as shown in the chart A manufacturing-led pick-up in activity in Germany is consistent with one of our key macro views - global growth will edge higher in 2020. Financial conditions remain highly accommodative in the euro area. Over time the gap between our financial conditions index and the Growth GPS should close. Yet, as we discuss in our latest Macro and market perspectives, the reaction of the parts of the economy that are sensitive to financial conditions in the euro area is much weaker than in the US. Potential downside risks include a re-escalation in trade tensions, particularly if they target Europe.

A turning point

Gauges of German economic activity, 2018-2020



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, ZEW, Sentix and Markit, January 2020. The chart shows sub-components of German manufacturing activity as per PMI indices, alongside measures of business and investor sentiment. Indexes have been standardized to bring all indexes to a common scale for comparability. We do this by scaling down each index by its respective volatility based on a sample of monthly data since 2014. The indexes are also normalized such that expansions in PMI-related series are consistent with positive values in the other data sets.

Investment themes

1 Growth edges up

- We see global growth edging higher thanks to easier financial conditions and moderating trade tensions.
- 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 after agreeing to a limited “phase one” trade deal, though there may be more turbulence. The U.S. adopted a revised North American trade pact. Both steps should allow global trading activity some breathing space, but U.S. protectionist measures could shift to Europe.
- We see greater uncertainty about China’s economic outlook – and the potential policy response – due to the coronavirus outbreak. As of now, we expect a limited global impact – but we will be monitoring for evidence of broader disruptions.
- Europe and emerging markets should see higher average growth rates as they recover from a weak 2019.
- Our macro regime work puts the business cycle in a slowdown regime – but we could see a shift to a risk asset-friendly goldilocks regime or a market unfriendly mild stagflation regime.
- **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 monetary policy easing is starting to filter through to economic activity.
- The Federal Reserve has reaffirmed that the bar for further policy easing is high. We believe there is too much focus on the Fed’s balance sheet whose role now is primarily about keeping the fed funds rate on target.
- Some large emerging market central banks, such as Russia and Brazil, are likely to keep cutting rates this year.
- 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 in Japan, as well as EM ex-China. We see greater focus on the role fiscal policy might play depending on the outcome of the U.S. election.
- 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

- A focus on sustainability can help make portfolios more resilient. A commonly held view is that sustainable investing requires giving up potential returns – we don’t think that’s true.
- 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.
- Geopolitical tensions remain high in the Middle East, and we believe markets are underestimating cyber risks ahead of the U.S. election. 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.

Week ahead

Feb. 3	U.S. ISM manufacturing purchasing managers' index (PMI); China, euro area manufacturing PMI	**Feb. 6**	German industrial orders
Feb. 4	U.S. December factory orders	**Feb. 7**	U.S. nonfarm payrolls; German industrial output

U.S. PMI data this week may confirm a rebound in manufacturing activity – as trading tensions have eased and easy financial conditions are likely filtering through to the real economy. The Democratic Iowa caucuses on Monday will kick off the primary season that will decide the party's presidential nominee, with the prospect that a clear leading candidate may not emerge for some time. This underscores our caution on U.S. equities due to rising political uncertainties.

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.

Granular views

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

Underweight | Overweight

Change in view: Previous → New

	Asset	
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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.

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