Weekly commentary

Feb. 10, 2020

BlackRock.

U.S. equities: we are still neutral

- We expect U.S. equities to perform in line with global markets this year, even after they have held steady during recent risk selloffs.
- We see global growth edging higher in 2020, though a broader pickup may be delayed due to the impact from the coronavirus outbreak.
- This week's German fourth-quarter GDP data may indicate the economy had slipped into recession.

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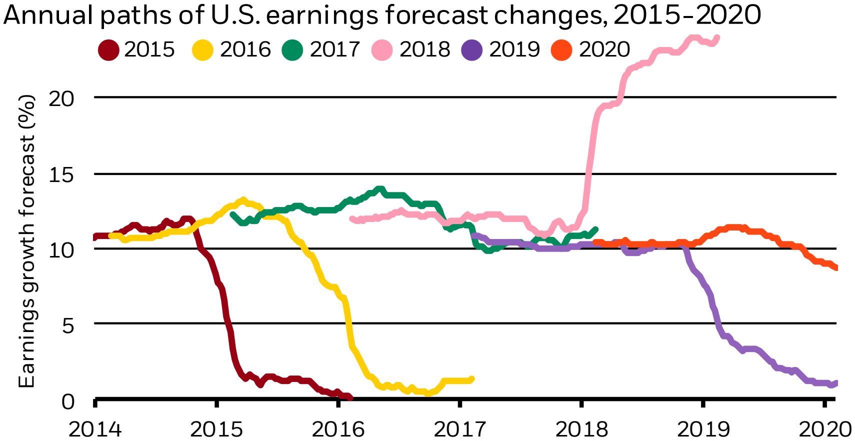
Market performance since early December has been a story of two phases: Emerging market (EM) equities had rallied and U.S. equities moved in line with global equities until the coronavirus outbreak in late January, reinforcing views in our 2020 Global Outlook. Since then, U.S. equities have outperformed and EM equities have stumbled. We see the former pattern reasserting itself over the next 6-12 months as growth recovers – and retain our neutral call on U.S. equities.

Chart of the week

Annual paths of U.S. earnings forecast changes, 2015-2020



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 Datastream, February 2020. Notes: Each year's earnings forecast path is based on analyst estimates on the earnings growth of the S&P 500 Index.

Analyst estimates on U.S. corporate earnings for a given year have often tended to start in the 10%-12% range in recent years. But the paths through each year – and the correlations with equity performance – can vary widely. See the chart above. Earnings forecasts in 2018 climbed throughout the year due to expectations for tax cut benefits, yet the U.S. equity market suffered its biggest annual loss since 2008 – partly due to tightening financial conditions. In 2019, earnings estimates trended lower through the year, but U.S. equities rallied nearly 30% – fueled by easier financial conditions due to the unusual late-cycle dovish pivot by key developed market (DM) central banks. What's in store for 2020? We see economic growth returning as a key market driver and an eventual uptick – even if delayed by the coronavirus impact – supporting positive earnings momentum. Yet rising uncertainty around the U.S. election and profit margin erosion typically seen in the late-cycle periods are likely to weigh on U.S. equity performance, we believe.

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BlackRock **Investment** Institute

We remain neutral on the outlook for U.S. equities despite encouraging earnings results. About half of the companies in the S&P 500 Index had reported results as of the end of January, with nearly 70% beating analysts' earnings estimates, according to Refinitiv data. This compares favorably to a long-term average of 64.9%. Analysts currently expect U.S. earnings to grow about 9% in 2020, a hair lower than the typical range for the start of the year. Yet we see that as an ambitious goal given potential for rising wages and other cost increases to further compress corporate margins. Our analysis of U.S. corporate profit margins over the stages of the business cycle since 1965 showed that profit margins have tended to contract in late-cycle periods. High earnings expectations, combined with these late-cycle dynamics and more attractive valuations in other regions, set a high bar for sustained U.S. outperformance.

Rising political uncertainty around November's U.S. election is another reason for caution on U.S. equities. Last week's Iowa Democratic caucuses – with their failures to produce timely results or to winnow down a crowded field – offered a taste of the potential for a highly volatile and noisy nine months ahead. A wide range of potential policy outcomes – in areas such as trade and tariffs, taxation, drug pricing, and regulation of energy and technology – could lead companies to defer spending plans and alter business models. This could heighten market volatility compared to recent years.

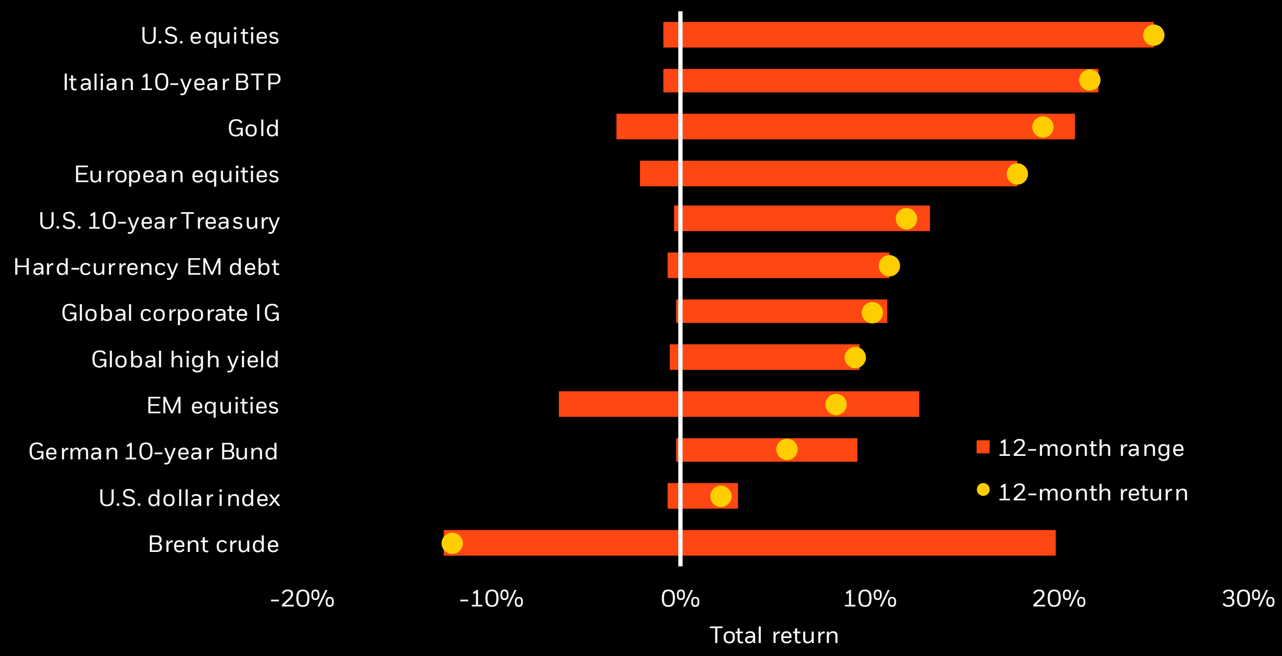
The bottom line: We stick to our view that global growth will edge higher in 2020 but expect the pickup to be delayed. U.S. equities could outperform on any further growth scares triggered by the coronavirus outbreak, given their quality bias and perceived resilience. But we remain neutral on U.S. equities, given elevated political uncertainties and the risk to margins. Overall, we stand by our moderate pro-risk stance, and expect an eventual growth pickup to support cyclical equity markets such as EM and Japan. Within U.S. equities we favor quality companies with above average return on equity, low leverage and strong cash flow.

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 and still accommodative financial conditions are supportive of growth. We are likely to see renewed weakness in global manufacturing weakness due to the virus impact in upcoming data. A broader growth pickup may be delayed, with the virus impact likely concentrated in the first half of the year. The ongoing 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, February 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.

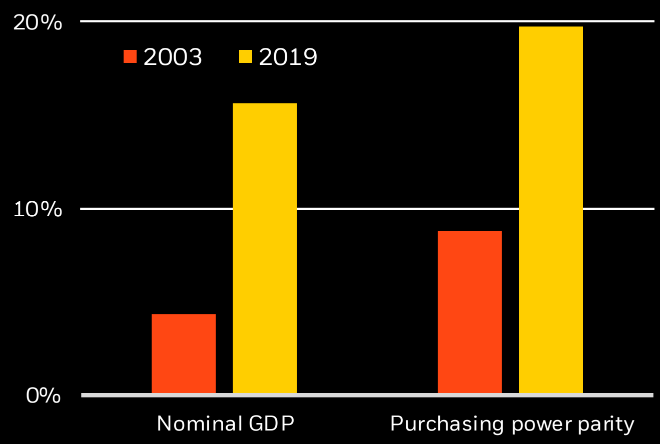
Macro insights

The coronavirus outbreak in China has sent jitters across financial markets, sparking a risk-off response and a raft of downgrades to the economic outlook. We believe it is too soon to gauge how activity will be affected, whether through production or sentiment. Yet the turnaround in growth momentum that had been developing through the end of 2019 will likely get postponed.

The macro impact is primarily driven by the response to the outbreak, not the virus itself. Historical comparisons with specific episodes such as SARS can only go so far. The Chinese economy has changed dramatically since 2003. It now makes up one-fifth of global GDP, as shown on the right. China's integration into global value chains is much deeper today than it was 17 years ago. While the effects of any disruption might be disinflationary for China as a drop-off in demand dominates, the adverse shock to global production could push up prices in other economies.

China – then vs. now

China as proportion of world GDP



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and the IMF, February 2020. Notes: The chart compares the size of China's economy in nominal and purchasing power parity terms to that of the global economy now and during the SARS outbreak.

Investment themes

1 Growth edges up

- We stick to our view that global growth will edge higher thanks to easier financial conditions, limiting recession risks.
- The growth mix should eventually shift as manufacturing recovers from coronavirus disruptions. We already see firming in interest rate-sensitive sectors, such as housing.
- We believe the U.S. and China have strong incentives to maintain the pause on their trade conflict after agreeing to a limited "phase 1" trade deal, reflected in China cutting tariffs on U.S. products last week, 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. We expect a limited global impact but are monitoring for evidence of broader disruptions.
- 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.
- China has eased monetary policy as a first response to cushion the drag from the coronavirus. And emerging market central banks in Asia have cut rates to counter the expected hit.
- 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

- Our preference for U.S. Treasuries and Treasury inflation-protected securities worked as portfolio resilience during the recent virus-related equity volatility. The moves also confirmed that some developed market government bonds, such as German bunds, work less well as diversifiers with yields near levels we consider to be their lower bounds.
- 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.
- 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 see a strong case for integrating sustainability into investment processes.

Week ahead

Feb. 10	China inflation
Feb. 11	UK gross domestic product (GDP) estimate, manufacturing output
Feb. 13	U.S. consumer price index
Feb. 14	Flash estimate German, euro area GDP; U.S. retail sales, industrial output, University of Michigan consumer sentiment

Expectations for German economic growth could sour following the slump in the country's industrial output in December – the biggest since 2009. Downward revisions could put the economy into recessionary territory. Our BlackRock Growth GPS, an estimate of where consensus GDP expectations may stand in three months' time, still points to a slight acceleration in Germany, but we caution that the current reading is yet to reflect any potential impact from the coronavirus outbreak.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, February 2020

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 maintain our overweight 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. We like TIPS as we still see 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

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, February 2020

	Asset	Underweight	Overweight	
Equities	United States			We keep U.S. equities at neutral. Rising uncertainty around the 2020 election and a wide range of policy outcomes may weigh on sentiment and prevent a repeat of outperformance.
Equities	Euro area	■■		We maintain European equities at 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 keep an overweight in 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 keep an overweight in EM equities and see them as beneficiaries from the global recovery. EM central banks are likely to stay on their easing paths, supporting growth and equity markets.
Equities	Asia ex-Japan			We hold Asia ex-Japan equities at neutral amid prospects of a growth uptick, even if delayed. We see China's economy eventually recovering from disruptions tied to the coronavirus outbreak.
Equities	Momentum	■		We maintain momentum as an underweight as valuations appear stretched. The factor has underperformed most other style factors in the second half of 2019.
Equities	Value			We keep value at neutral due to its pro-cyclical nature and prospects for renewed yield curve steepening.
Equities	Minimum volatility			We keep min-vol at 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 hold quality as an overweight. 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 maintain U.S. Treasuries at neutral, 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		■	The asset class has rallied amid the coronavirus outbreak, making an entry point less attractive now. We still see potential for higher inflation amid U.S. wage pressures and like TIPS in strategic portfolios.
Fixed Income	German bunds	■		We remain underweight bunds as they provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
Fixed Income	Euro area peripherals	■		We hold an underweight in 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 keep global investment grade credit as an underweight. 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 keep global high yield as an overweight, supported by stable monetary policy and the prospect of a growth inflection.
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 hold local-currency EM debt as 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 maintain Asia fixed income as an overweight. 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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