

Weekly commentary

Dec. 9, 2019

BlackRock

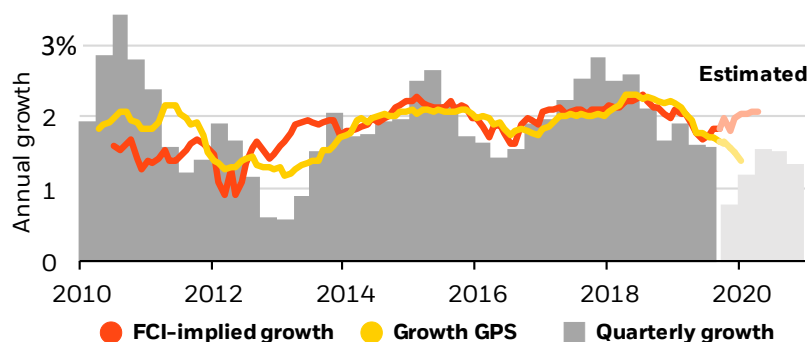
Guide to our 2020 outlook

- Our 2020 Global outlook introduces three new investment themes, as well as a revamped tactical asset allocation framework.
- We see growth stabilizing and gradually picking up over the next six to 12 months thanks in part to easy financial conditions.
- The UK election this week – and a new government as a result – could offer some clarity on policy directions.

We see a big shift in the macro environment in the year ahead – as the dovish monetary policy pivot of 2019 fades as a market driver. We detail these views in our [2020 Global outlook](#). The piece features a revamped tactical asset allocation framework – with high-level directional views across asset classes, as well as granular views within – all scaled by conviction level. Our modest pro-risk stance is little changed, but we have made meaningful changes under the hood.

Chart of the week

BlackRock G3 Financial Conditions Indicator and Growth GPS, 2010-2019



Sources: BlackRock Investment Institute, Consensus Economics and Reuters polls, as of December 2019. Notes: The Growth GPS shows where consensus GDP forecast may stand in 'three months' time, shifted forward by three months. The orange line shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS, shifted forward by six months. The gray area shows annualized actual growth rates on a quarterly basis; values after Sept 30, 2019 are consensus estimates. 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.

We introduce three new investment themes for 2020. The first of these: Growth edges up over the course of the year, picking up the baton to support risk assets. The unusual late-cycle, dovish pivot by central banks has led to a dramatic easing in financial conditions. The impact of such easing on the real economy typically comes with a lag – but has been particularly delayed this time as it has been partially offset by the protectionist push. See the gap between our Growth GPS (yellow line) and where we would expect growth estimates to be purely implied by financial conditions (orange line) on the chart above. What would challenge this outlook? If U.S.-China trade talks break down, or protectionist pressures broaden and ratchet higher, it could undermine business and market sentiment, cutting short the growth uptick we expect.



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Powerful structural trends are testing limits – and threaten to intersect with the near-term outlook and become market drivers. Rising inequality and a surge in populism have implications for taxes and regulation. Trade frictions and deglobalization are weighing on growth and boosting inflation. Interest rates are hitting lower bounds and crimping the effectiveness of monetary policy. And sustainability-related factors such as climate change are having real-world consequences, and affecting asset prices as investors start to pay attention.

This was the overarching backdrop for the discussions when some 100 BlackRock investment professionals gathered in November to debate 2020’s market outlook. Our outlook publication features key takeaways from these debates. Highlights include: how yields hitting lower bounds are prompting a rethink of the role of government bonds as portfolio ballast; the risk of supply shocks from deglobalization and climate change lifting inflation over time; the prospects for a pause in U.S.-China trade tensions; and the potential for divergent policy outcomes in the U.S. presidential election in 2020.

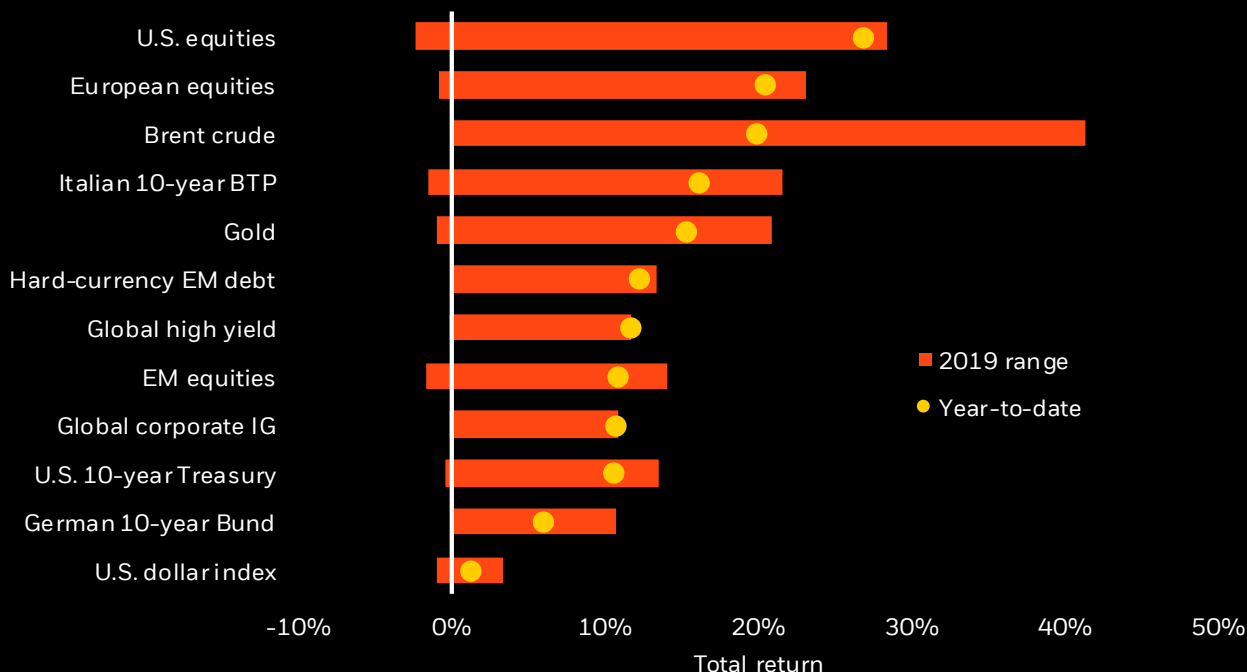
We also unveil a new framework for tactical asset allocation. The first step is understanding the current macro regime – and the likelihood of potential transitions between regimes. This is key, because different regimes have different implications for asset returns. We assess current valuations and incorporate the views of BlackRock experts. This results in a new set of views on broad asset classes for the next six to 12 months, as well as granular views within asset classes, including equity factors. We scale these views according to our conviction. Three overall takeaways: We are modestly positive on risk assets; neutral on global duration and cash; and see room for a cautious cyclical rotation. Under the hood, many of our calls on sub-assets have changed due to the shift in economic and market dynamics. For example, within equities we have downgraded the U.S. market to neutral, with concerns about rising political uncertainty around the 2020 elections. We have at the same time upgraded Japanese equities to moderately overweight, expecting Japanese companies to benefit from a global manufacturing recovery and domestic fiscal stimulus. See pages 4 and 5 for our new asset views tables.

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, as well as signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing. We see the dovish pivot by major central banks as having 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 and gradually pick up over the next six to 12 months thanks in part to easy financial conditions. See our [macro data dashboard](#).

Assets in review

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

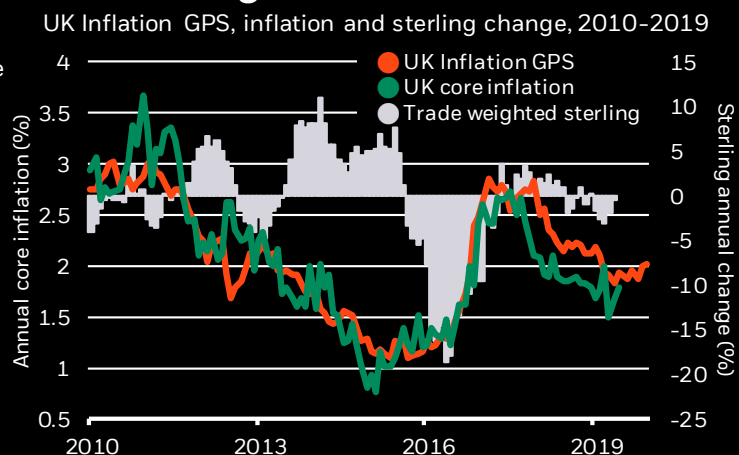


Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end 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. BIIM1219U-1030517-2/6

Macro insights

Since the Brexit referendum in 2016, the UK economy has experienced mild stagflation. Growth has slowed due to a rise in uncertainty and a decline in investment, while inflation accelerated on the back of sharp sterling depreciation. The economy and currency should benefit if the political picture stabilizes next year – but risks remain. The UK general election on Dec. 12 should provide more clarity on the Brexit outcome, while moderate fiscal stimulus and a decline in uncertainty should support growth in the near term. The Bank of England is likely to remain on hold – the market is pricing no cuts over the next year – while sterling could benefit from the improved growth prospects. But falling household saving levels, rising household debt and poor productivity growth represent risks to the outlook. Much will depend on the election outcome, with both major parties vowing to spend heavily but a Labor government promising larger fiscal injections.

The sterling effect



Sources: BlackRock Investment Institute, Bank of England and Office for National Statistics, with data from Refinitiv, December 2019. Notes: The BlackRock UK Inflation GPS shows where core (excluding food and energy) consumer price inflation may stand in six months' time. The green line shows actual UK core inflation. The grey area shows the year-on-year change in the broad trade weighted sterling index.

Investment themes

1 Growth edges up

- We see an inflection point in global economic growth 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 incentives for the U.S. and China to hit pause on their trade conflict are strong in 2020. U.S. and China negotiators are working toward a "Phase 1" trade deal, yet there could be turbulence along the way. A key milestone will be Dec. 15, the date scheduled for the next round of U.S. tariff increases.
- The likelihood seems to have risen of a revised North American trade pact being ratified soon.
- Sideways trade pressures 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.
- Risks of a no-deal Brexit have diminished. Yet a general election on Dec. 12 has created uncertainty on what follows.
- **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 bar for further easing by the Federal Reserve looks to be 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 passing of the baton from monetary to fiscal stimulus. 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*.
- 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

- This year's sharp shift on monetary policy and interest rate expectations has pushed some bond yields near levels we consider as their lower bound, implying less room 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.
- **Market implication:** We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and like inflation-protected securities against inflation risks.

Week ahead

Dec. 10 China trade, inflation and lending data; German ZEW Economic Sentiment

Dec. 12 UK general elections; European Central Bank policy meeting

Dec. 11 The Federal Reserve monetary policy meeting ends; U.S. consumer price index

Dec. 13 U.S. retail sales

Markets are bracing for the high-stake UK elections this week. Latest polls showed the Conservative Party in a leading position, yet a hung parliament cannot be ruled out. Brexit uncertainty over the past three years has weighed heavily on the UK economy. Improved policy clarity of a new government, against the improving global growth backdrop, could help lift UK assets. Yet risks remain that medium-term Brexit uncertainties won't disappear overnight even with a new government.

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

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.
			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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