

Weekly commentary

Jan. 13, 2020

BlackRock

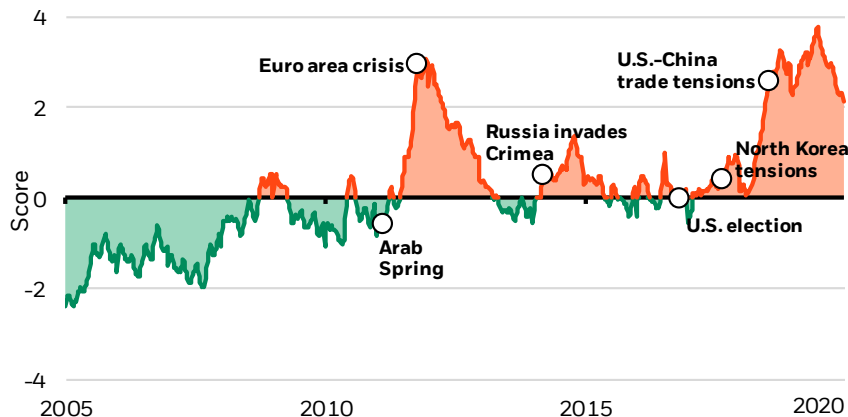
Geopolitical risks on our 2020 radar

- The recent sharp escalation in U.S.-Iran tensions serves as a reminder of the potential for flare-ups in geopolitical risks as we enter 2020.
- We see global growth stabilizing and gradually picking up over the next six to 12 months, thanks in part to easy financial conditions.
- Strategic competition between the U.S. and China, especially in tech, is likely to persist despite the signing of a limited “Phase 1” trade deal.

U.S.-Iran tensions have spiked in recent weeks with the U.S. killing of a top Iranian military leader triggering retaliation. This reminds us of still heightened geopolitical risks across many dimensions, even as we see a relatively benign backdrop for risk assets in 2020. The U.S.-China trade conflict – 2019’s dominant geopolitical risk – has paused, yet we expect enduring strategic rivalry between the two countries. We see U.S. Treasuries as a key source of portfolio ballast.

Chart of the week

BlackRock Geopolitical Risk Indicator-Global, 2005-2020



Sources: BlackRock Investment Institute, with data from Refinitiv. Data as of January 3, 2020. Notes: We identify specific words related to geopolitical risk in general and to our top-10 risks. We then use text analysis to calculate the frequency of their appearance in the Refinitiv Broker Report and Dow Jones Global Newswire databases as well as on Twitter. We then adjust for whether the language reflects positive or negative sentiment, and assign a score. A zero score represents the average BGRI level over its history from 2003 up to that point in time. A score of one means the BGRI level is one standard deviation above the average. We weigh recent readings more heavily in calculating the average.

The market’s overall attention to global geopolitical risks sits at elevated levels, as proxied by our BlackRock Geopolitical Risk Indicator (BGRI). See the chart above. Our BGRI measures the attention to top 10 risks in analyst reports, social and financial media. We had raised the likelihood of growing Gulf tensions late last year, and still see ongoing and heightened tensions despite the avoidance of major confrontation between the U.S. and Iran. The market reaction to date to Gulf tensions has been muted, partly reflecting the decreasing heft of the Middle East in determining global oil prices, with the U.S. now a net oil exporter. Yet a sustained escalation that results in repeated attacks on oil facilities or disruptions to shipping in the Persian Gulf – more materially threatening global growth – would likely change this story.



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We see a relatively benign backdrop for risk assets in 2020, with easier financial conditions supporting a growth uptick. Read details in our [2020 Global Outlook](#). A key underpinning assumption is that global trade tensions move sideways this year. Recent developments in this area have been positive for markets: U.S.-China trade tensions appear to be going sideways, and the U.S.-Mexico-Canada Agreement on trade looks set to pass the U.S. Congress soon. Yet any broader surge in geopolitical risks in the Middle East or elsewhere could undermine the sentiment in – and the performance of – risk assets. What other geopolitical risks should we look out for in 2020? Below we detail three broad dimensions.

First: We are seeing fragmentation at a global level across a range of dimensions, including ideology, trade and technology. Technology decoupling between the U.S. and China is underway and will force countries and businesses to navigate this evolving landscape. We expect such tensions to persist even after a limited “Phase 1” trade deal that may temporarily defuse U.S.-China trade tensions. Domestically, political polarization is reaching a high point in many countries. The U.S., for example, faces a contentious presidential election with the potential for starkly divergent policy outcomes. We have downgraded U.S. equities to neutral on a tactical basis amid rising election uncertainty. The second is an increase in global protests, partly fueled by rising income and wealth inequality and facilitated by social media. Many governments are ill-equipped to respond. With limited monetary and fiscal maneuvering room, this could lead to further unrest in any downturn.

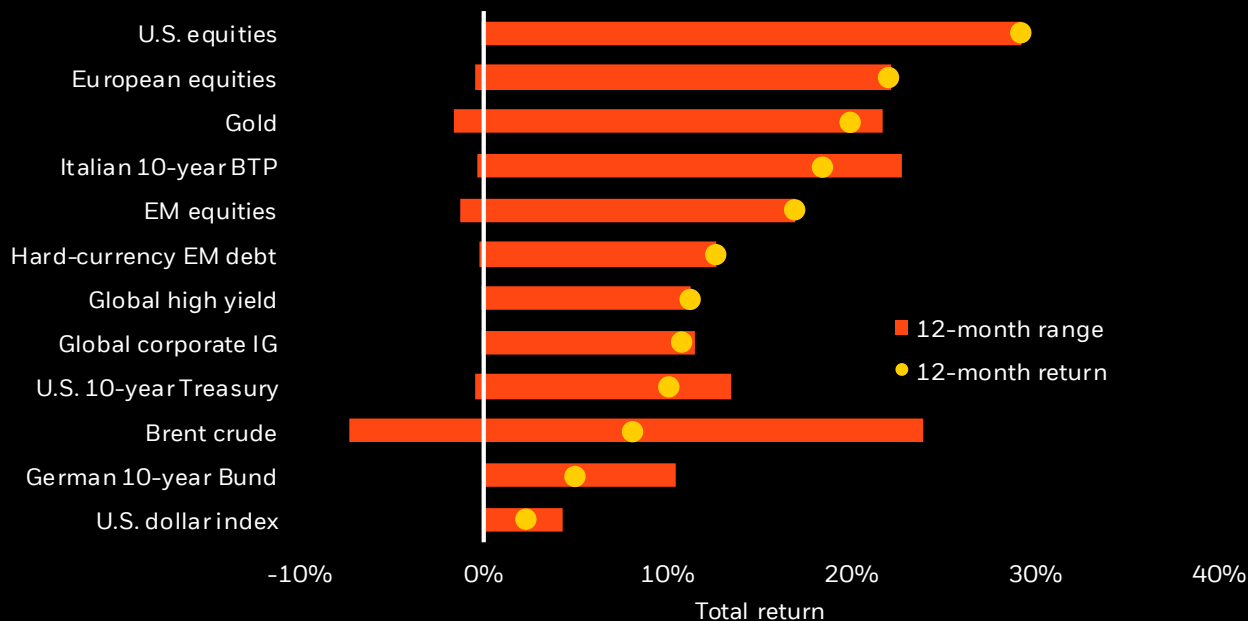
The third is cybersecurity. Tensions are elevated between the U.S. and many adversaries such as Iran and North Korea, which have the capability to mount attacks on critical infrastructure and institutions. An uptick of “ransomware” attacks against cities and states with relatively poor defenses may be a sign of things to come. Markets look to be complacent about such risks: the attention to cyberattacks has been on a steady decline since late 2017, [our BGR I shows](#). U.S. Treasuries and their inflation-protected peers have done well to cushion portfolios against recent risk selloffs – and we prefer them in both tactical and strategic portfolios. Government bonds in Europe and Japan have diminished ability to serve such as role as their yields near lower bounds.

Market backdrop

An escalation in Middle East tensions has spurred a cautious start to the year for risky assets. Yet the broader backdrop remains relatively benign with trade tensions abating and financial conditions still accommodative. We are on the watch for more signs that global manufacturing may be bottoming out. We see the dovish pivot by major central banks as having run its course for now. We expect growth to stabilize and gradually pick up over the next six to 12 months as easier financial conditions start filtering through and sideways protectionist pressures give global trade activity some breathing room. See our [macro data dashboard](#).

Assets in review

Selected asset performance in the past 12 months



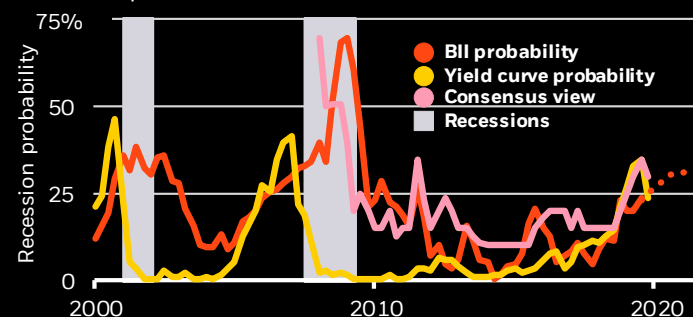
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2020. Notes: The two ends of the bars show the lowest and highest returns over the last 12 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 Bond 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

Our model shows a one-in-four probability of a U.S. recession in the next 12 months. In 2019, the Bloomberg consensus and a probability based on the U.S. Treasury yield curve were both showing rising chances of a recession, with both reaching the highest levels since the previous recession. Yet both metrics have converged to our more sanguine recession risk view. Financial vulnerabilities have been a key factor triggering past recessions. Gauging recession risks takes more than the shape of the yield curve or the gyrations of monthly activity data. Our financial vulnerabilities index (FVI) has been inching higher, but the current level doesn't suggest an imminent risk to the expansion. Financial sector vulnerabilities are limited by the post-crisis re-regulation of the banking system along with continued balance sheet repair and deleveraging in the household sector. Corporate sector vulnerabilities are rising but are not out of line with history.

Recession risks

Recession probabilities, 2000-2020



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, Jan. 2020. Notes: The chart shows the estimated four-quarter ahead probability of a U.S. recession according to the Bill model, the Bloomberg consensus and the U.S. Treasury yield curve implied probability. The Bill probability is estimated by gauging the probability of that future growth – projecting a four-quarter average of GDP based on recent data trends – below a certain threshold. The probability is based on an adjusted distribution of historical GDP data relative to GDP, our financial conditions indicator and our FVI. The threshold is consistent with growth rates seen during U.S. recessions since 1985. The 2020 probabilities are based on a range of likely outcomes of financial conditions, financial vulnerabilities and growth.

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 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 reaffirmed last week 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

- 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.
- 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. 14 China trade

Jan. 16 Japan machinery orders

Jan. 15 UK inflation; the U.S. and China due to sign “Phase 1” trade deal

Jan. 17 China industrial output and retail sales; University of Michigan consumer surveys; euro area inflation

The “Phase 1” trade deal would confirm a pause in the U.S.-China trade conflict that has weighed on global growth over the past year. Yet we have seen little progress toward resolving structural U.S.-China rivalry, and expect the strategic competition and technology decoupling between the two countries to persist in the longer term.

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	Change in view		Previous	New
	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.

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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