Weekly commentary

BlackRock.

Nov. 25, 2019

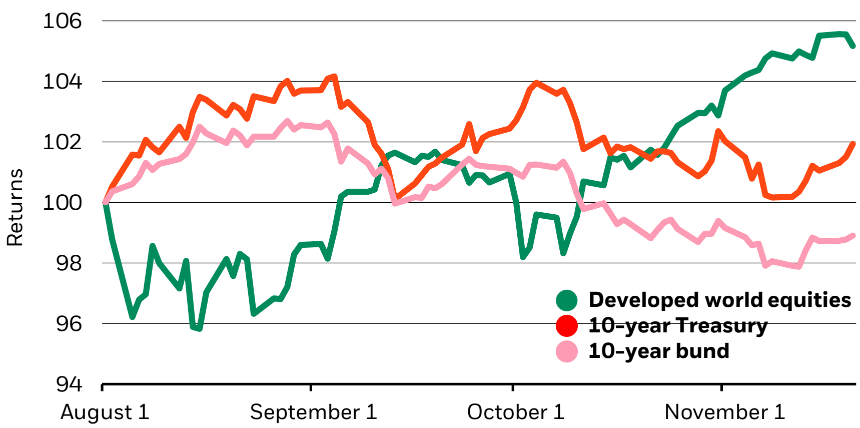
A rethink on government bonds' role

- A resumption of monetary easing and ultra-low bond yields this year challenge the role of government bonds as portfolio ballast.
- We see growth stabilizing and gradually picking up over the next 6 to 12 months thanks in part to loose financial conditions.
- Markets will focus on U.S. manufacturing and personal consumption data to see if consumer spending remains a bedrock of the economy.

Monetary policy may have reached its limit in stoking growth – and interest rates in some developed markets are nearing the lowest levels that central banks can feasibly set. This forces a rethink of the strategic role of government bonds in portfolios. The duration of bond indexes has been rising as yields decline, making them more sensitive to future moves in rates. We advocate looking beyond market cap-based weights in sizing allocations: higher yielding U.S. Treasuries offer greater ballast against risk-asset selloffs than euro area or Japanese bonds.

Chart of the week

Equity and bond returns since Aug. 1, 2019



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, November 2019. Notes: The chart shows the returns of developed world equities, U.S. 10-year Treasuries and German 10-year bunds. Returns are rebased to 100 as of Aug. 1, 2019. Indexes used are the MSCI World and Datastream 10-year government bond benchmarks.

One consequence of rock-bottom rates across the developed world: some government bonds may have diminishing ability to cushion multi-asset portfolios against large drawdowns in equities. The chart above gives a glimpse of this challenge – which we see remaining relevant on a strategic horizon. Equity and U.S. Treasury returns were generally mirror images of each other during the August equity selloff and corresponding recovery, but German government bonds (bunds) offered less of a cushion against the equity selloff. U.S. Treasury yields fell sharply, but the decline in bund yields stalled at record lows, suggesting investors saw limits to how much lower bund yields could fall. When risk appetite returned, bunds sold off more sharply than U.S. Treasuries.

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Reduced ballast and meagre expected returns in certain core government bond markets requires a rethink of the starting point for strategic asset allocations to government bonds, in our view. Government bonds have traditionally played four roles in portfolios: returns, via income and capital gains; perceived safe store of value; ballast and liquidity in risk-asset selloffs; and for some the need to meet regulatory and capital requirements. The post-crisis monetary easing has propelled a rally in government bonds, aiding the performance of diversified portfolios such as a traditional “60/40” split of equities and bonds. Today’s low yields mean that we should not expect such returns from bonds in the future.

The dramatic drop in government bond yields this year, taking nearly a third of global bonds into negative-yielding territory at one point, has raised serious questions about their role in strategic asset allocations. Policy rates in the euro area – already in negative territory – may be nearing an “effective lower bound (ELB)”, or the minimum level of interest rates that central banks can feasibly set. As short-term rates fall toward their ELBs, and bond yields follow, the risk/return profile for bonds becomes increasingly asymmetric. Bond prices have more room to fall materially than rise materially in response to broader market events or shocks. Falling yields mean that the compensation for holding duration in the euro area and Japan has collapsed. Increasing low or zero coupon issuance is increasing the average duration of benchmark bond indexes. This makes them more sensitive than in the past to swings in interest rates, with potential for greater volatility.

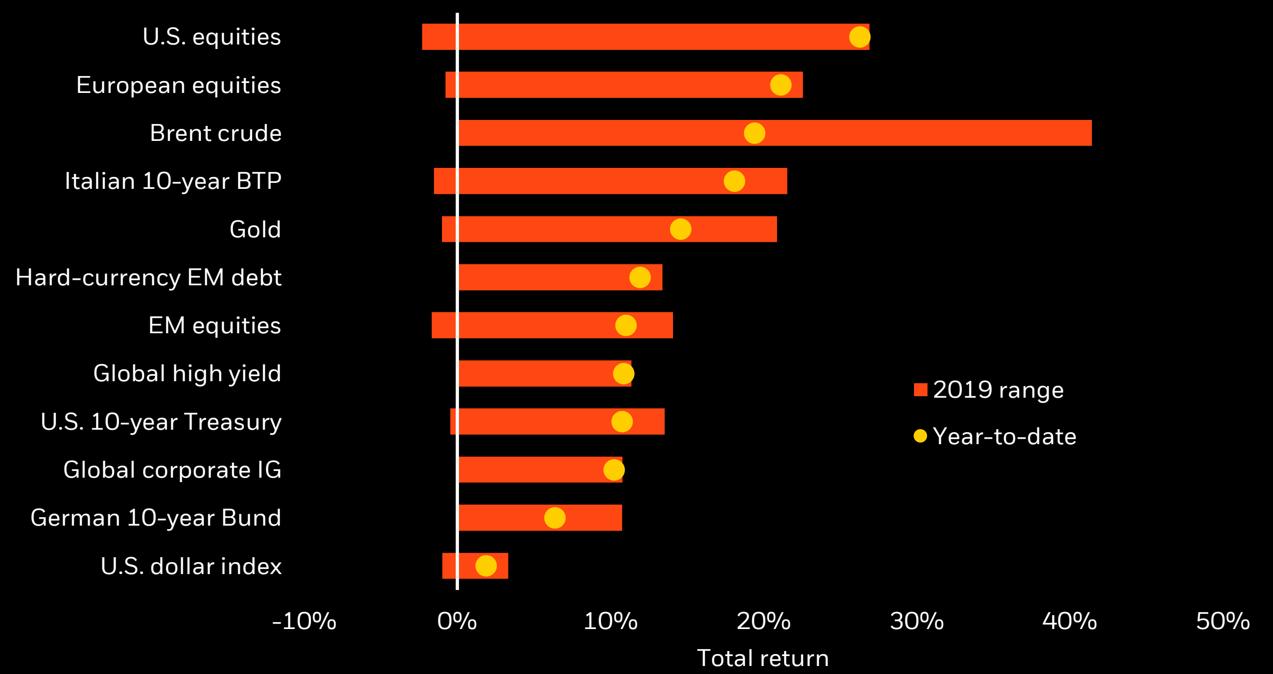
Another risk to the ballast property of government bonds: a weakening or breakdown in the negative correlation between stocks and bonds that has prevailed for most of the past two decades. The inverse correlation could face pressure due to potential policy shifts, such as a pick up in fiscal stimulus or a supply shock from deglobalization. Bottom line: The current ultra-low yield environment challenges the role of government bonds as portfolio ballast. We prefer to overweight higher-yielding U.S. government bonds in strategic asset allocations, and see a diminished role for euro area and Japanese government bonds.

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 6 to 12 months thanks in part to loose financial conditions. See our macro data dashboard.

Assets in review

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



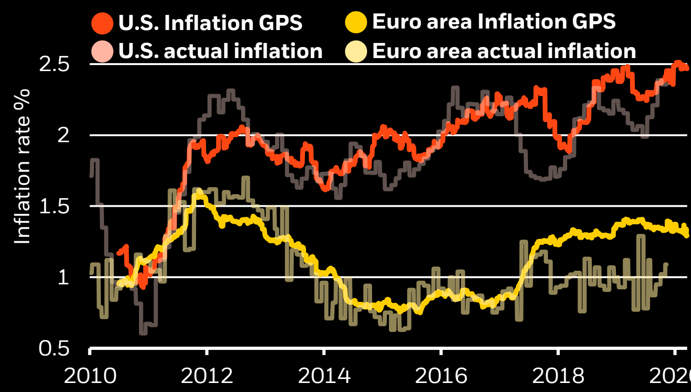
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end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

Macro insights

October inflation readings confirmed the stickiness in U.S. core consumer prices and stability in the euro area. Where next? Markets are pricing in downside risks, yet we believe there are upside risks stemming from deglobalization and wage growth. Core inflation in the U.S. is now consistent with the Federal Reserve's 2% target. In the euro area, CPI remains subdued. Consensus views suggest a softer path for inflation with downside risks. In markets, five-year inflation forwards imply U.S. CPI at 1.8% and euro area inflation at 1.3%, both below central bank targets. Yet we believe a negative supply shock arising from deglobalization may push up input costs at a time when labor markets are tight and wage growth is rising. Our Inflation GPS for the U.S. core CPI points to a 2.5% annual rate in six months, indicating some scope for a mild acceleration. Our Inflation GPS for the euro area also suggests that inflation may creep up.

Room on the upside

U.S. and euro area Inflation GPS and inflation, 2010-2020



Sources: BlackRock Investment Institute and Refinitiv Datastream, November 2019. Notes: The U.S. Inflation GPS shows where core (excluding food and energy) consumer price inflation (CPI) may stand in six months' time. The Euro area Inflation GPS shows where the core harmonized index of consumer prices (HICP) inflation may stand in six months' time. The faded lines show actual U.S. core CPI and actual core euro area HICP inflation. Forward-looking estimates may not come to pass.

Investment themes

1 Protectionist push

- U.S. and China negotiators are working toward a "Phase 1" trade deal. Agreement has so far proven elusive due to additional demands – including tariff rollbacks by China and language on forced technology transfers by the U.S. – as well as a bill relating to Hong Kong that passed the U.S. Congress.
- We see a temporary truce in 2020 as likelier than not. Both sides have incentives that point toward a pause, and China has so far compartmentalized trade talks from broader political differences with the U.S. 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 this year.
- Yet persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle — a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- Risks of a no-deal Brexit have diminished. Yet a general election on Dec. 12 has created uncertainty on what follows.
- **Market implication**: We favor reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- Central banks have eased policy significantly with the aim of offsetting the trade shock and sustaining the economic expansion in the face of a manufacturing recession.
- We expect growth to stabilize over 6-12 months and see a mild pick up thanks in part to loose financial conditions and a manufacturing recovery. This should take the reins from monetary policy in supporting risky assets.
- We believe the Federal Reserve and other central banks are done with policy easing barring other shocks. We don't expect China to provide major stimulus as its economy slows further, reflected in this week's small rate cut.
- The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct impact of tariffs and in the long term due to the hit to production capacity, complicating the case for policy easing.
- 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*.
- **Market implication**: We like U.S. equities and EM debt. We are tactically overweight euro area government bonds: a relatively steeper yield curve brightens their appeal even at low yields. We are neutral European equities and credit.

3 Raising 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 sell-offs.
- A weakening or breakdown of the negative correlation between stocks and bonds could also undermine the portfolio ballast role of government bonds.
- **Market implication**: We prefer U.S. Treasuries over German and Japanese government bonds on a strategic basis.

Week ahead

Nov. 27 – U.S. durable goods data will offer a glimpse at the health of the manufacturing sector. We have seen strong consumer spending helping offset manufacturing weakness in past months in the U.S. economy. The personal consumption data due on the same day will test if this view still holds true.

Nov. 29 – Markets will watch the euro area inflation data for November for any signs of firming prices. Our base case for 2020 is for the global economic expansion to plod on, with growth stabilizing and inflation firming.

Asset views

Views from a U.S. dollar perspective over a 6-12 month horizon

Asset class		View	Comments
Equities	U.S.	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like min-vol and quality, which have historically tended to perform well during economic slowdowns.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	U.S. government bonds	▼	We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	—	Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis' tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key parts of our income thesis.
	European sovereigns	▲	The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for euro area investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We like EM bonds for their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina's woes) and in countries not directly exposed to U.S.-China tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

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