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WEEKLY COMMENTARY • MAY 13, 2019

Key points

1. Last week's selloff is a reminder of the potential for late-cycle bouts of volatility. We remain risk-on, yet advocate maintaining portfolio ballast.
2. The U.S. increased tariffs on $200 billion worth of Chinese imports, dialing up pressure on China as the two continued their trade talks.
3. Energy ministers of key oil producing countries will meet this week amid rising tensions in the Gulf.

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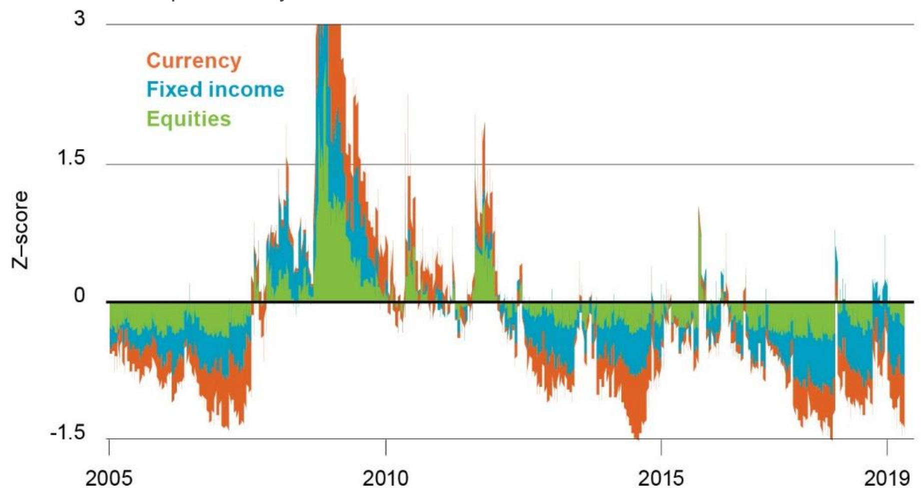
1 Lessons on low market volatility

A selloff in risk assets last week – driven by fading expectations for a U.S.-China trade deal – has shattered the calm after a prolonged period of low market volatility in 2019. We remain cautiously pro-risk, but see potential for further bouts of volatility in this late-cycle period. This argues for maintaining ballast in portfolios.

Chart of the week

Cross-asset implied vol by asset class, 2005-2019



Sources: BlackRock Investment Institute, with data from Bloomberg, CBOE, Bank of America Merrill Lynch, and JP Morgan, May 2019. Notes: We use the CBOE VIX Index, MOVE Index and JPMorgan Global FX Volatility Index to represent the implied volatility in equities, fixed income and currency markets respectively. A z-score of 1 means the volatility level is one standard deviation above the cross-asset vol average for the period from the start of 1990 to May 8, 2019. The cross-asset vol is calculated as the average of the z-scores for the three asset classes. We omitted the peak of the volatility spike in late 2008 and early 2009 during the global financial crisis, in order to better present the trend for the rest of the selected period.

The market outlook had become more benign this year, following a selloff in the last quarter of 2018. Cross-asset implied volatility – a gauge of volatility across the equity, fixed income and foreign exchange markets – recently dropped to near record-low levels. See the chart above. Volatility in the currency markets has been particularly low, dragging down the average level across different markets. The backdrop behind low vol: a potential prolonged holding pattern by key central banks – most notably the Federal Reserve – coupled with a slowing but still growing global economy. Yet earlier last week market volatility spiked, after U.S. President Donald Trump's tariff threat on China upended the expectation for an imminent trade agreement. The VIX Index, a gauge of the U.S. stock market volatility, jumped to the highest level since late January.

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Reasons for caution

Last week's market moves serve as a reminder that unusually low levels of market volatility likely do not accurately reflect the risks in this late-cycle period. Geopolitical risk is a key example. The market's attention to global trade tensions – as reflected in chatter about the risk in analyst reports, traditional and social media – had dropped sharply from the peaks in mid-2018, our BlackRock geopolitical risk indicator (BGRI) shows. This was pointing to greater potential for market volatility should the risk flare up, as it has over the past week. We could still see a U.S.-China trade deal that includes a Chinese pledge to purchase more U.S. goods, among other items, yet implementation and enforcement will be challenging, in our view.

We still favor risk assets, given the ongoing global economic expansion and the prospect for central banks to stay accommodative. Yet macroeconomic volatility is increasing in this late-cycle period, reflected in the rising dispersion of analysts' GDP forecasts. Our research suggests periods of rising macro volatility have historically featured greater market volatility. To be sure, we see major central banks on hold in the months ahead, providing a stable policy backdrop. But U.S. growth is slowing and economic data could become more noisy in the months ahead after a sharp inventory buildup in the first quarter. Another potential source of volatility: In China, we see signs of a growth recovery, but the scale and longevity of the government's stimulus package may soon be called into question.

Bottom line: Recent spikes in market volatility remind us a balanced approach is key to investing in the late-cycle period. We still see a narrow path ahead for risk assets to move higher – but there are risks that could knock markets off track. U.S. government bonds have historically played an important role in cushioning portfolios against such bouts of volatility. In equities, we favor the U.S. and emerging markets, with a focus on quality companies that can sustain earnings growth even in a slowing economy.

2 Week in review

- The U.S. raised tariffs on Chinese imports worth $200 billion as the two sides continued negotiations to resolve their trade dispute. China threatened to retaliate but stopped short of giving details.
- Global stock markets dropped to six-week lows. Perceived "safe haven" assets benefited, with U.S. Treasury yields declining and the Japanese yen hitting the highest level in more than six weeks.
- U.S. consumer prices data was slightly weaker than expected, supporting the case for the Fed to remain on hold for the time being. Europe's economic activity data indicated that the area's economy might have bottomed out. Germany's industrial output rose more than expected in March, though industrial orders disappointed.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-2.1%	15.8%	8.0%	2.0%
U.S. Small Caps	-2.5%	17.2%	-0.6%	1.6%
Non-U.S. World	-3.0%	10.1%	-5.8%	3.3%
Non-U.S. Developed	-2.6%	10.3%	-5.6%	3.5%
Japan	-2.6%	5.6%	-9.1%	2.5%
Emerging	-4.5%	7.6%	-8.1%	2.8%
Asia ex-Japan	-4.9%	8.8%	-7.6%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.5%	2.2%	5.3%	2.5%
U.S. TIPS	0.4%	3.5%	3.2%	2.6%
U.S. Investment Grade	0.1%	5.7%	6.7%	3.6%
U.S. High Yield	-0.5%	8.2%	6.1%	6.3%
U.S. Municipals	0.5%	3.9%	6.1%	2.2%
Non-U.S. Developed	0.7%	1.6%	-0.7%	0.8%
EM $ Bonds	-0.2%	7.2%	7.2%	6.0%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	-0.3%	31.3%	-8.8%	$70.62
Gold	0.5%	0.2%	-2.7%	$1,286
Copper	-1.8%	2.7%	-11.4%	$6,126

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.3%	-2.1%	-5.7%	1.12
USD/Yen	-1.0%	0.3%	0.5%	109.95
Pound/USD	-1.3%	1.9%	-3.8%	1.30

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of May 10, 2019. Notes: Weekly data through Friday. Equity and bond performance are measured in total index returns in U.S. dollars. U.S. large caps are represented by the S&P 500 Index; U.S. small caps are represented by the Russell 2000 Index; Non-U.S. world equity by the MSCI ACWI ex U.S.; non-U.S. developed equity by the MSCI EAFE Index; Japan, Emerging and Asia ex-Japan by their respective MSCI Indexes; U.S. Treasuries by the Bloomberg Barclays U.S. Treasury Index; U.S. TIPS by the U.S. Treasury Inflation Notes Total Return Index; U.S. investment grade by the Bloomberg Barclays U.S. Corporate Index; U.S. high yield by the Bloomberg Barclays U.S. Corporate High Yield 2% Issuer Capped Index; U.S. municipals by the Bloomberg Barclays Municipal Bond Index; non-U.S. developed bonds by the Bloomberg Barclays Global Aggregate ex USD; and emerging market $ bonds by the JP Morgan EMBI Global Diversified Index. Brent crude oil prices are in U.S. dollars per barrel, gold prices are in U.S. dollar per troy ounce and copper prices are in U.S. dollar per metric ton. The Euro/USD level is represented by U.S. dollar per euro, USD/JPY by yen per U.S. dollar and Pound/USD by U.S. dollar per pound.

3 Week ahead

May 14 Japan current account; eurozone industrial production (IP)

May 15 China's IP, retail sales and other data; U.S. retail sales, IP; eurozone first-quarter gross domestic product flash

May 18 Deadline for Trump's decision on auto tariffs; Australia's federal election

May 19 Energy ministers from the Organization of the Petroleum Exporting Countries (OPEC) and allies meet

OPEC energy ministers will meet this week amid rising tensions in the Gulf. The U.S. has tightened its sanctions on Iran, and the U.S.-Saudi Arabia relationship is under heightened pressure. See our BlackRock geopolitical risk dashboard for more on Gulf tensions and the rest of our top-10 risks. The U.S. administration is expected to make a decision on tariffs on auto imports by May 18. We see that deadline likely to be postponed, as the U.S. may keep the auto tariffs issue on the backburner before the trade talks with China conclude.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are still challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance, such as a global growth rebound. We prefer higher-quality, globally oriented firms.
	Japan	—	Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲	Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. We see the greatest opportunities in EM Asia.
	Asia ex-Japan	▲	The economic backdrop is encouraging, with near-term resilience in China and solid corporate earnings. We like selected Southeast Asian markets but recognize a worse-than-expected Chinese slowdown or disruptions in global trade would pose risks to the entire region.
Fixed income	U.S. government bonds	—	We are cautious on U.S. Treasury valuations, but still see the bonds as important portfolio diversifiers. We see recent moves lower in yields as excessive and advocate patience before increasing exposure. We prefer shorter-dated and inflation-linked bonds and expect a gradual yield curve steepening, driven by still-solid U.S. growth and the Fed's stated willingness to tolerate temporary inflation overshoots.
	U.S. municipals	▲	We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	—	Increased demand for income amid stable monetary policy, signs of more conservative corporate behavior and constrained supply remain supportive. We prefer an up-in-quality stance overall, but recent spread widening may also offer an attractive opportunity in BBB-rated credits. We favor bonds over loans in high yield.
	European sovereigns	▼	Low yields, European political risks, and the potential for a market reassessment of pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. European sovereign bonds offer an attractive income opportunity for U.S.-dollar based investors on a currency-hedged basis.
	European credit	▼	"Low for longer" ECB policy should reduce market volatility and support credit as a source of income, yet valuations are relatively rich after a rally this year. We prefer high yield credits, supported by muted issuance and strong inflows. Euro high yield also offers a significant spread premium to its U.S. counterparts.
	EM debt	—	Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	—	We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia. Portfolio rebalancing could cause material capital inflows into China, as the country opens its markets to foreign capital.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "safe-haven" appeal but gains could be limited by a high valuation and a narrowing growth gap with the rest of the world.

▲ Overweight — Neutral ▼ Underweight *Given the breadth of this category, we do not offer a consolidated view.

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