Weekly commentary

BlackRock

Nov. 4, 2019

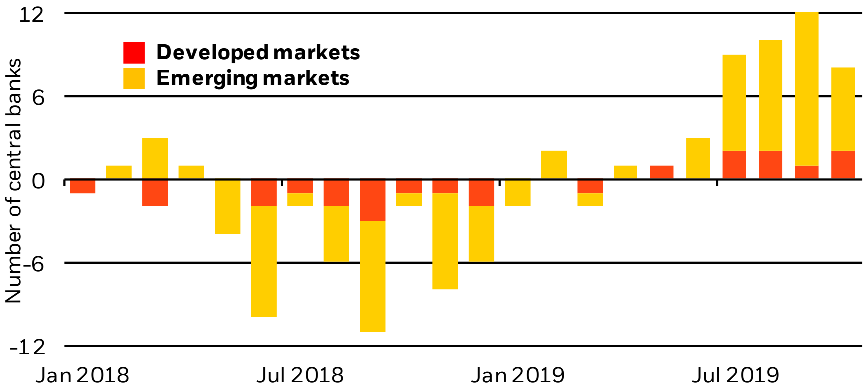
Late-cycle easing may end soon

- The Federal Reserve signaled no more rate cuts for now, in line with our view that there is limited need for further easing.
- We expect a growth pickup in 6-12 months but still see risks that manufacturing weakness caused by protectionism may spill over.
- Markets will assess the impact from the trade tensions on China's economy from this week's data including trade and inflation.

Global central banks have delivered an unusual late-cycle dovish pivot this year – to extend an already-long economic expansion. The Fed's rate cut last week was the latest installment of this dovish push. Yet the Fed also signaled the potential completion of its late-cycle rate cuts, significantly raising the bar for additional easing, in our view. Key reasons: a potentially tricky combination of slowing growth and inflation creeping higher; and the prospect for firmer growth in 2020 as easier financial conditions filter through to the broader economy.

Chart of the week

Net number of rate-cutting central banks, 2018-2019



Sources: BlackRock Investment Institute, with data from Bloomberg and MSCI, November 2019. Notes: The stacked bars show the net number of central banks that cut interest rates in each calendar month. Our selection is based on MSCI's categorizations of developed markets (DM) and emerging markets (EM), with some modifications. We used a total of 13 DMs and 25 EMs for this analysis. On the DMs list, we grouped together the 10 DMs in the euro area as one as the European Central Bank (ECB) sets their monetary policy and removed Singapore as it manages its monetary policy through currency exchange rates settings and not interest rates. On the EMs list, we omitted Greece as the ECB sets its policy.

Many central banks have switched gear this year. See the chart above for the net number of central banks cutting rates. Among them, the European Central Bank cut rates in September for the first time since 2016 and announced a restart of its asset purchase scheme; Brazil's central bank has cut its benchmark rates to a record low just last week. But some central banks, including the Fed, may be closer to the end of this easing cycle. The Fed signaled a shift to a more data-dependent approach, and we now see a much higher hurdle for it to cut rates again in coming months. Markets are now pricing in just over one quarter percentage point rate cut in the coming 12 months.

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BlackRock **Investment** Institute

One key reason for the Fed to end its late-cycle easing: The U.S. economy has held steady as robust consumer spending helps offset weakness in manufacturing activities and business investment. Third-quarter gross domestic product (GDP) grew at a better-than-expected 1.9% on an annualized basis, just below 2% in the second quarter. U.S. job growth slowed less than expected in October, underpinning the resilience in consumer spending. Looking ahead, there are some tentative indications that the deceleration in manufacturing may be ebbing. We see no signs of a meaningful turnaround in growth yet, but expect easier financial conditions – the result of an easing in monetary policy and a potential lull in trade tensions – to filter through to the broader economy over 6-12 months. As a result we see only limited risk of a U.S. recession over the next year.

The dovish pivot by central banks – a key investment theme featured in our Global investment outlook – has supported risk assets. Yet this is a 2019 story. It is unclear whether further monetary easing would be the best remedy for shoring up slower growth in the U.S. or the euro area, in our view. We also believe monetary policy alone won't be able to address the next economic downturn, as it is increasingly exhausted with interest rates nearing zero or even below in many developed markets – and weak inflation expectations dragging on actual inflation.

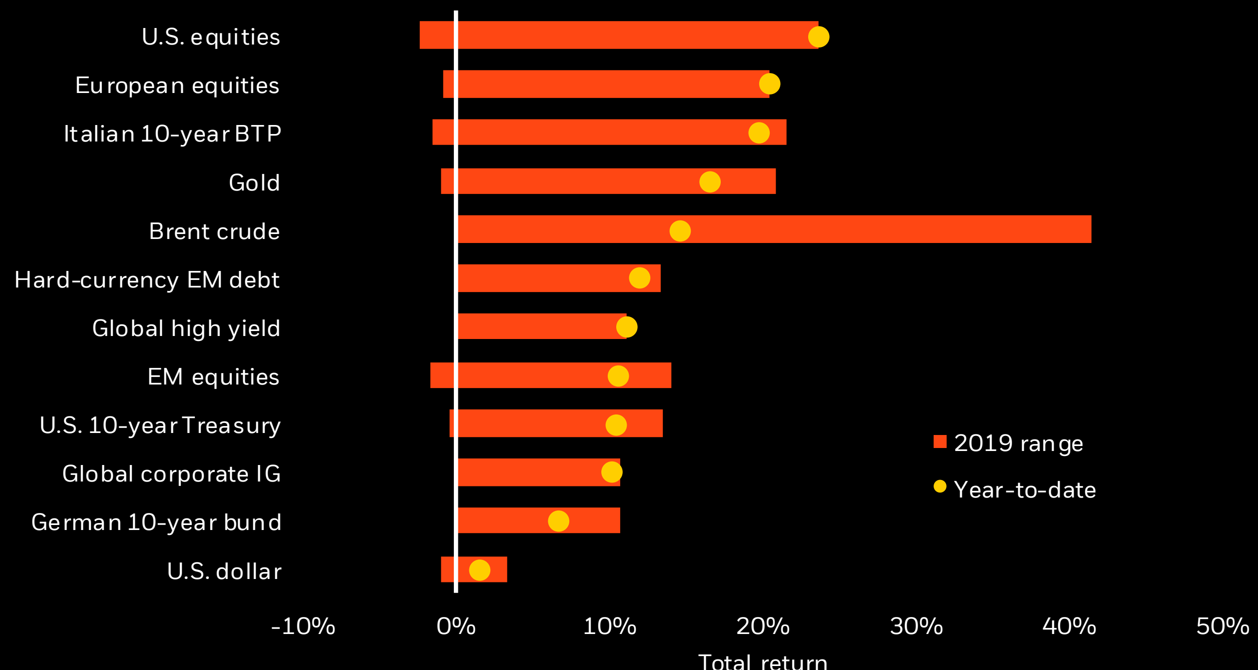
Bottom line: We maintain our overweight in U.S. equities and our neutral view on U.S. corporate credit. As credit remains part of our income thesis and we see only limited recession risks in the U.S., we feel comfortable holding both investment grade and high yield positions into the year-end. What would it take to change our view? An unexpected tightening in financial conditions that leads to a spike in recession risks. Geopolitical frictions have become a key driver of the global economy and markets, but so far we do not see it alone as sufficient to tip the U.S. economy into a recession, especially in the absence of major financial imbalances or systemic vulnerabilities. That said, the U.S.-led protectionist push has injected additional uncertainty into business investment decisions, threatening to weaken economic activity. We stress the importance of building portfolio resilience in this environment, and see government bonds remaining important portfolio stabilizers – even at today's low yield levels.

Market backdrop

A perceived lull in geopolitical frictions has boosted risk assets. Yet we are on the watch for any signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing. Markets have tempered expectations of further Fed rate cuts, suggesting the dovish pivot by major central banks has 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 a pickup in global growth in the next six to 12 months, fueled by loose financial conditions. See our macro data dashboard.

Assets in review

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



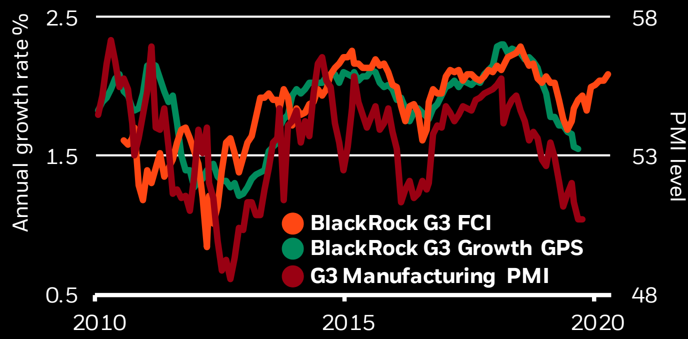
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end 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. BIIM1119U-995542-2/5

Macro insights

Economic activity in the U.S. and the euro area is subdued. But within the PMI data there are some suggestions that the manufacturing slowdown is bottoming out. The German manufacturing PMI is in contraction territory – but did tick up marginally. And euro area weakness seems to be mainly in Germany. The euro area PMI nudged higher to a reading above the contractionary threshold and the French series rose nearly two points. New orders in the euro area moved up even as companies were running down stocks at the fastest pace in three years. This boosted the ratio of orders to inventories - a proxy for manufacturing demand. There were signs of stabilization in the U.S. too, as the composite PMI edged higher. Financial conditions have eased in recent months thanks to policy easing, helping to offset the impact of the protectionist push. The historical relationship between our Financial Conditions Indicator and Growth GPS points to potential for a growth pickup in the next six months.

Still subdued

BlackRock G3 FCI, Growth GPS and PMI, 2010-2020



Sources: BlackRock Investment Institute, IHS Markit and Bloomberg, October 2019. Notes: 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 six months. The Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. The red line is the composite PMI for the G3. Forward-looking estimates may not come to pass.

Investment themes

1 Protectionist push

- U.S. and Chinese negotiators are working toward a "phase 1" trade deal. A limited deal may be signed by the two countries' leaders in November, but timing is uncertain with the cancellation of the APEC Summit in Chile.
- All existing tariffs remain in place. The next round of tariff increases is set for December. Structural issues over technology, national security, and human rights make a comprehensive deal unlikely.
- 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 favour reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- The record-long U.S. economic expansion looks unlikely to morph into a deeper downturn any time soon, supported by healthy household spending.
- Central banks have eased policy significantly with the aim of offsetting the trade shock and to sustain the economic expansion in the face of a deepening manufacturing recession.
- Yet we believe the Fed has finished its late-cycle insurance rate cuts and is on hold for several months barring a sharp growth downturn or a risk asset selloff. China has stuck to a stable monetary policy stance, even in the face of an economic slowdown.
- 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*.
- Markets have trimmed expectations of further Fed easing. We expect a growth pickup over 6-12 months, thanks to loose financial conditions. That will take the reins in supporting risky assets. See the macro insights box above.
- **Market implication**: We like U.S. equities and EM debt. We are overweight eurozone government bonds: a relatively steeper yield curve brightens the appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- Most government bonds play an important role in building portfolio resilience – even at low yield levels – both on a tactical basis and in long-term portfolios.
- Last month's sharp reversals in the momentum and value factors show the importance of minimizing portfolio exposure to pockets of the market where pricing appears stretched.
- **Market implication**: We prefer U.S. Treasuries over German bunds for portfolio diversification on a strategic basis. The recent underperformance of bunds relative to Treasuries in recent risk-off events suggests core euro area government bond yields are approaching their perceived effective lower bound.

Week ahead

China data – Markets will watch economic data releases including Caixin services purchasing managers' index (PMI), trade and inflation to assess the impact from ongoing U.S.-China trade frictions. China's economic growth slowed to 6% year-on-year in the third quarter, the slowest since 1992, under the pressure of the trade war with the U.S. In the latest sign of challenges faced by the world's second-largest economy and manufacturing powerhouse, factory activity shrank for the sixth consecutive month in October. We see a lull in China's growth. The policy stance in China could ease further to help stabilize growth, but we see the bar for triggering more stimulus set higher than in previous years.

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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