



WEEKLY COMMENTARY • SEPT. 3, 2019

Key points

- 1 Global trade frictions have intensified this summer. This reinforces a key plank of our outlook but may challenge our moderately pro-risk stance.
- 2 Risk assets rebounded last week after selling off amid trade worries. U.S. consumer data were mixed, and the risk of a no-deal Brexit rose.
- 3 U.S. consumers have supported U.S. growth as manufacturing slumps. Jobs data this week will provide evidence on whether this trend persists.

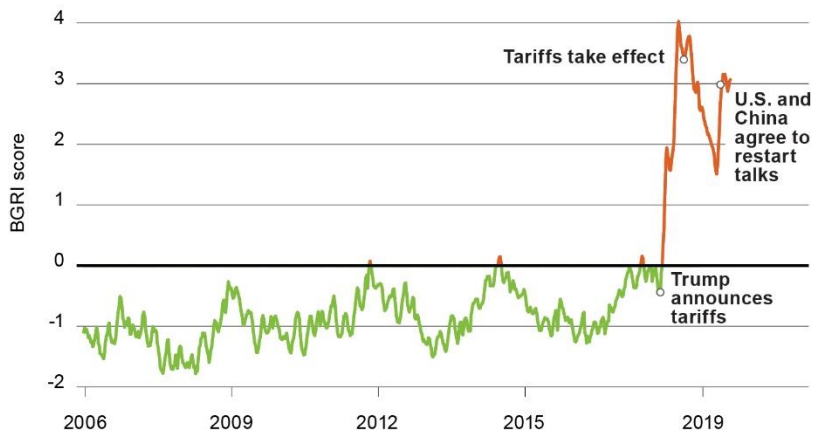
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1 Back to school: our themes put to the test

U.S.-China trade tensions have escalated, echoing our [midyear outlook](#) *protectionist push* theme, and bond yields have fallen to new lows. We do not see a near-term recession, with no clear signs of financial vulnerabilities and central banks helping extend the cycle. Yet the protectionist push has been stronger than we expected, raising the risk of accidents. This has potential to challenge our modestly pro-risk stance.

Chart of the week

BlackRock global trade tensions BGRI, 2006-2019



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, August 2019. 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 BGRI’s risk scenario is for illustrative purposes only and does not reflect all possible outcomes as geopolitical risks are ever-evolving.

The U.S.-China trade standoff has materially escalated amid tit-for-tat actions, just as summer ends in many parts of the globe and back-to-school season begins. The latest twists and turns include newly announced U.S. and Chinese tariffs, and increasingly unpredictable U.S. policy actions, particularly around trade, that threaten the longstanding institutional underpinnings of the global economy. Our indicator of market attention to the geopolitical risk of worsening [global trade tensions](#) has risen in response, though is still short of record highs struck in the summer of 2018. See the uptick in the far right of the chart above.

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## Intensifying protectionist push

We identified the protectionism push in our [midyear investment outlook](#) as the most important market driver – and this risk has only intensified since. The recent escalation in the U.S.-China conflict has injected more uncertainty into business planning, weakening economic activity. Our [macro indicators](#) point to a decelerating global expansion. And we view a comprehensive U.S.-China deal as unlikely in the near term, with the best outcome now a trade truce until November 2020. We now expect some level of tariffs on most of U.S.-China trade for an extended period of time. Trade spats have also continued to broaden beyond the U.S. and its allies, and other geopolitical risks abound, including the near-term prospect of a “hard Brexit.” See our [Geopolitical risk dashboard](#).

The protectionist push has so far outweighed the market impact of the central bank dovish pivot that underpins another of our key outlook themes: *Stretching the cycle*. Additional central bank stimulus, actual and expected, should help stretch the cycle. After the Federal Reserve disappointed markets in July, we see the European Central Bank likely announcing a stimulus package and the Fed cutting rates again this month. The Fed may cut by more than we initially expected, but we still view the one percentage point of additional easing that markets are pricing in by end-2020 as excessive. This is partly because monetary policy is no cure for a full-blown trade war. There is [limited policy space to deal with a future downturn](#). And while the trade war is unambiguously bad for growth, we still see potential for U.S. inflation to rise in the near term due to the direct one-off impact of tariffs, and in the longer term, due to trade tensions’ adverse impact on production capacities. As for growth signposts, we are closely watching U.S. labor market and consumer data for signs of spillovers from a manufacturing slump.

Bottom line: Our key investment themes and views remain unchanged, but we are cautiously watching fundamentals and price action due to the intensifying protectionist push and resulting plunge in yields. A worsening of this backdrop would challenge our broad preference for equities over bonds. Government bonds displayed their ability to provide portfolio ballast this summer, but some may be nearing their [effective lower bound in yields](#). Within equities we still like U.S. stocks for their reasonable valuations and quality bias.

## 2 Week in review

- Equities rebounded from steep declines earlier in the month driven by rising trade tensions and macro uncertainty.
- U.S. consumer data were mixed amid a manufacturing slowdown and indications tariffs are weighing on sentiment. In Europe, disappointing Germany IFO data provided more evidence that the German economy is likely to contract again in the third quarter.
- The UK’s prime minister announced plans to suspend the UK parliament ahead of Queen Elizabeth’s October 14 speech. The UK parliament now has limited time to prevent a no-deal Brexit outcome, raising the likelihood of an intense period of political turbulence in the UK. Italy’s political crisis abated amid an agreement to form a coalition government, reducing the risk of snap election later this year.

## Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	2.8%	18.3%	3.0%	2.0%
<b>U.S. Small Caps</b>	2.5%	11.8%	-12.5%	1.7%
<b>Non-U.S. World</b>	1.1%	9.2%	-3.4%	3.3%
<b>Non-U.S. Developed</b>	0.9%	10.1%	-3.4%	3.5%
<b>Japan</b>	0.4%	7.0%	-5.1%	2.6%
<b>Emerging</b>	1.2%	4.2%	-4.2%	2.9%
<b>Asia ex-Japan</b>	0.6%	4.2%	-6.5%	2.7%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	1.8%	12.3%	-22.3%	\$ 60.43
<b>Gold</b>	-0.4%	18.5%	26.7%	\$ 1,520
<b>Copper</b>	0.8%	-4.8%	-6.4%	\$ 5,676

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	0.2%	8.6%	10.4%	1.5%
<b>U.S. TIPS</b>	0.4%	9.1%	7.5%	1.7%
<b>U.S. Investment Grade</b>	0.1%	13.9%	13.3%	2.8%
<b>U.S. High Yield</b>	0.5%	11.0%	6.6%	5.7%
<b>U.S. Municipals</b>	0.1%	7.6%	8.7%	1.7%
<b>Non-U.S. Developed</b>	-0.1%	5.9%	5.7%	0.4%
<b>EM \$ Bonds</b>	0.5%	13.5%	13.8%	5.2%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	-1.4%	-4.2%	-5.8%	1.10
<b>USD/Yen</b>	0.9%	-3.0%	-4.2%	106.31
<b>Pound/USD</b>	-1.0%	-4.7%	-6.5%	1.22

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Refinitiv Datastream. As Aug. 30, 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

**Sept. 3**

U.S. August ISM manufacturing PMI; UK parliament reconvenes

**Sept. 5**

U.S. August ISM non-manufacturing PMI, factory orders; Germany July factory orders

**Sept. 4**

China August Caixin Services PMI; Bank of Canada rate announcement

**Sept. 6**

U.S. August employment report

A strong U.S. consumer has been the linchpin of U.S. growth recently as manufacturing slows amid rising trade tensions and macro uncertainty. U.S. economic data this week may offer an important signpost on whether that consumer strength is persisting, after mixed consumer data last week. Consensus estimates point to U.S. non-farm payroll growth declining to 155,000 from 164,000 last month. Labor data, particularly income and work-week figures, and the non-manufacturing PMI report will be key to watch for signs of ongoing consumer resilience. Our [Macro GPS](#) shows the global economy decelerating this year, but our financial conditions indicator still points to conditions supportive of growth.

## Asset class views

Views from a U.S. dollar perspective over a three-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, which has 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 have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply-demand dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	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 part of our income thesis.
	European sovereigns	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver – or even exceed – stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. 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 have upgraded EM bonds to overweight on 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 believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities in Latin America and in countries not directly exposed to U.S.-China trade 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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