

BlackRock

2020 Global Outlook

BlackRock
Investment
Institute

Testing limits



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Growth should edge higher in 2020, limiting recession risks. This is a favorable backdrop for risk assets. But the dovish central bank pivot that drove markets in 2019 is largely behind us. Inflation risks look underappreciated, and the lull in U.S.-China trade tensions could end. This leaves us with a modestly pro-risk stance for 2020.

- The 2020 macro environment marks a big shift from the dynamics of 2019, when an unusual late-cycle dovish turn by central banks helped offset the negative effect of rising trade tensions. The U.S. dovish pivot looks to be over for now. Any meaningful support in the euro area will have to come from fiscal policy, and we do not see this in 2020. Emerging markets (EMs), however, still have room to provide monetary stimulus.
- This makes growth the key support of risk assets. Our base case is for a mild pickup supported by easy financial conditions, with a slight rise in U.S. inflation pressures. We see China's economy stabilizing, but little appetite for replays of the large-scale stimulus of the past. We see the growth uptick taking root in the first half of the year, led by global manufacturing activity and rate-sensitive sectors such as housing.
- The main risk to our outlook is a gradual change in the macro regime. One such risk: Growth flatlines as inflation rises. This might pressure the negative correlation between stock and bond returns over time, reducing the diversification properties of bonds.
- A deeper economic slowdown is another risk to consider. There has been a pause in the U.S.-China trade conflict, but any material escalation of global trade disputes could undermine market sentiment and cut short the expected manufacturing and capex recovery that underlies our tactical views.
- We remain modestly overweight equity and credit due to the firming growth outlook and pricing that still looks reasonable against the macro backdrop. Yet we have made meaningful changes to our granular views. We see potential for a bounce in cyclical assets in our base case: We prefer Japanese and EM equities, as well as EM debt and high yield. We are cautious on U.S. equities amid 2020 election uncertainties.
- Yields that are approaching lower bounds make government bonds less effective portfolio ballast, especially outside the U.S. This causes a rethink of portfolio resilience. We prefer U.S. Treasuries to other core government bonds, both in 2020 and in strategic portfolios. We like short maturities in the near term and inflation-linked bonds as resilience against risks of regime shifts.

Testing limits

Powerful structural trends are testing limits — and threaten to intersect with the near-term outlook and become market drivers. Rising inequality and a surge in populism have implications for taxes and regulation. Trade frictions and deglobalization are weighing on growth and boosting inflation. Interest rates are nearing lower bounds and crimping the effectiveness of monetary policy. And sustainability-related factors such as climate change are having real-world consequences, affecting asset prices as investors pay growing attention.

Some 100 BlackRock investment professionals gathered in New York, on Nov. 12-13 for our 2020 Outlook Forum to debate how these trends will play out over the next year. We introduce three new investment themes against this backdrop. We expect a modest pickup in global growth. As a result, we see less room for the kind of dovish monetary policy surprises from major central banks that boosted markets in 2019. Growth will have to drive risk asset returns in 2020 instead. Yields hitting lower bounds and inflation risks prompt a rethink of the role of bonds as portfolio ballast. See [pages 4-6](#) for deep dives on each theme.

What does this mean for investing? Understanding the current macro regime — and potential transitions between regimes — is key ([page 7](#)). We assess current valuations and incorporate the views of BlackRock experts ([page 8](#)). This results in a set of views on broad asset classes for the next six to 12 months ([page 9](#)) and has implications for longer-term, strategic portfolios ([page 10](#)).

We then share insights from the 2020 Outlook Forum debates. The usual late-cycle limit — overheating followed by recession— is not evident. Instead, we see a risk of supply shocks lifting inflation over time ([page 11](#)). The U.S. elections loom large. Policy outcomes are wide across fiscal, trade and regulatory policy ([page 12](#)). We see a pause in U.S.-China tensions, but with bouts of turbulence along the way and no let-up in structural frictions. China has diminishing willingness to stimulate global growth ([page 13](#)). Corporate profits already face challenges, including rising wages, regulatory scrutiny and potential corporate tax hikes ([page 14](#)).

The publication ends with granular views across asset classes ([page 15](#)).

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.

Implication: We maintain a moderate pro-risk stance and see potential for cyclical assets such as Japanese and EM assets to outperform tactically.

Policy pause

We see economic fundamentals driving markets in 2020, with less risk from trade tensions and less scope for monetary easing surprises or fiscal stimulus. Major central banks appear intent on maintaining easy policies — and interest rates and bond yields look likely to linger near lows.

Implication: Income streams are crucial in a slow-growth, low-rate world. We like EM and high yield debt.

Rethinking resilience

Yields are testing lower limits in developed markets, making many government bonds less effective portfolio ballast in equity market selloffs. A focus on sustainability can help add resilience to portfolios as markets wake up to environmental, social and governance (ESG) risks.

Implication: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and like inflation-protected securities against inflation risks.

Themes

Growth edges up

We see an inflection point in global economic growth over the first half of 2020. The unusual late-cycle, dovish pivot by central banks has led to a dramatic easing in financial conditions. The impact of such easing on the real economy typically comes with a lag – but has been particularly delayed this time due to the protectionist push. This is illustrated by the *Growth disconnect* chart in the gap between our Growth GPS (yellow line) and where we would expect growth estimates implied by financial conditions to be (orange line). We see a shallow growth pickup that pushes the economy back to the late-cycle norm of trend-like expansion. Yet easy financial conditions are unlikely to fully translate into stronger growth, partly because of the offsetting force of protectionism.

We believe the incentives for the U.S. and China to hit pause on their trade conflict are strong in 2020, although there could be turbulence along the way. Trade pressures moving sideways should allow global trade activity some breathing space. We see China's economy stabilizing but little appetite among its leadership for the large-scale stimulus that has buoyed the global economy in the past (page 12). Europe and EM economies should see higher average growth as they recover from a weak 2019.

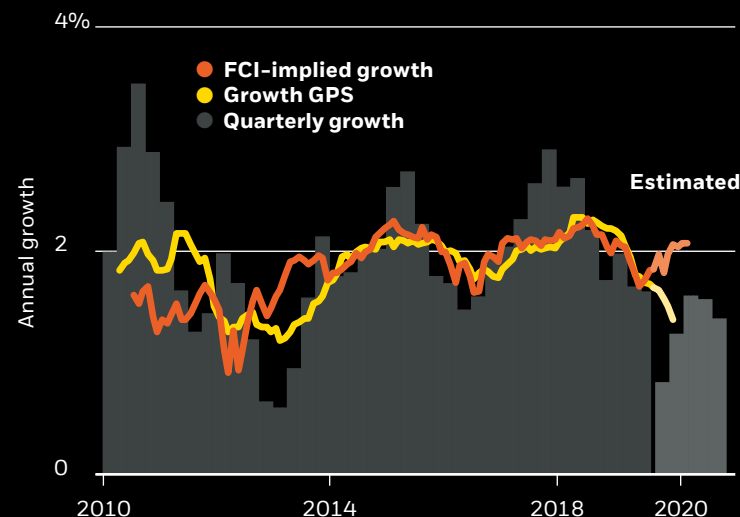
We also see a shift in the mix of global growth. The rebound is likely to be led by the manufacturing sector (notably cars, capital goods and semiconductors), as well as interest rate-sensitive sectors such as housing and, to a lesser extent, business investment. The lack of large-scale stimulus in China should limit its magnitude. U.S. consumer spending is set to slow marginally as the savings rate rises, yet robust wage gains and ongoing – albeit slowing – jobs growth should keep the consumer resilient overall.

In sum, the expected growth pickup underpins our moderately pro-risk stance. And the firming that we expect to see in global industrial production and trade can pave the way for cyclical assets to outperform on a tactical basis, particularly those with beaten-down valuations. This supports our call for modestly overweight positions in regions and companies dependent on global trade, such as Japanese and EM equities. Easy monetary policy in the EM world supports this view.

The primary risk? U.S.-China talks break down, or protectionist pressures broaden and ratchet higher. This could undermine business confidence and market sentiment, cutting short the growth uptick that we expect.

Growth disconnect

BlackRock G3 FCI and Growth GPS, 2010-2020



Sources: BlackRock Investment Institute and Consensus Economics, November 2019. Notes: The Growth GPS shows where consensus GDP forecast may stand in three months' time, shifted forward by three months. 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 by six months. The shaded areas show annualized actual growth rates on a quarterly basis; values after Sept. 30, 2019 are consensus estimates. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates. Forward-looking estimates may not come to pass.

We expect a modest global growth pickup in the first half of 2020. This limits recession risk and is a favorable backdrop for risk assets, in our view.

Themes

Policy pause

We see economic fundamentals driving markets in 2020, and less scope for monetary easing and other policy surprises. The bar for further easing by the Federal Reserve looks to be high — with no policy action barring a significant growth slowdown or an unwanted tightening in financial conditions. Elsewhere, the European Central Bank (ECB) and the Bank of Japan (BoJ) may deliver further monetary easing given persistent inflation undershoots. Both central banks have limited policy space left, however, and the side effects of negative rates — particularly on banks' profitability and ability to lend — increasingly undermine their policy efforts.

The main point: We see little scope for the type of unexpected dovish pivot that drove markets in 2019. Instead, monetary policy looks set to stay easy across the U.S., euro area and Japan, with rates below equilibrium levels. The lagged effect of policy easing should start to filter through to economic activity.

Easy monetary policy, low rates and low bond yields offer a favorable backdrop for income-generating assets, in our view. We see room for many EM central banks to ease, supporting EM growth. This underpins our overweights in EM debt, particularly local-currency, and in high yield.

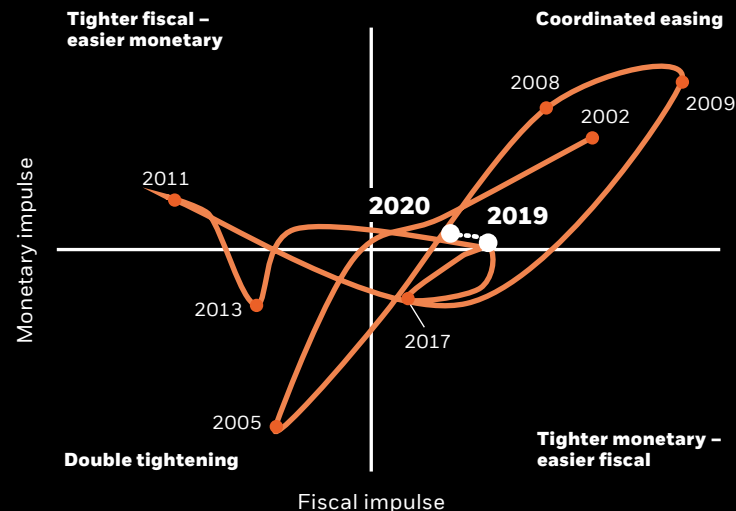
The policy debate will increasingly focus on a potential hand-off from monetary to fiscal stimulus. This echoes our call for greater coordination between monetary and fiscal authorities to deal with the next downturn. We don't see this happening in 2020 — indeed, fiscal policy is set to become a little less easy. The *Limits to stimulus* chart shows this in the small movement toward the left in 2020.

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. Changing market expectations around the election outcome — and its implications for trade, taxes, public investment and regulation — look more likely as drivers for industry sectors and the overall market. We see any fiscal support from China as limited and not delivering the countercyclical boost it has in the past. A material escalation in U.S.-China trade tensions could shift China's fiscal policy stance. But our base case is that tensions move sideways and do not escalate ([page 11](#)).

The bottom line: We see little chance of meaningful fiscal stimulus, but believe even modest shifts toward fiscal easing may have outsized market impact.

Limits to stimulus

Monetary and fiscal impulses in major economies, 2002-2020



Sources: BlackRock Investment Institute, with data from the IMF and Refinitiv, November 2019. Notes: We used weights based on GDP in purchasing power parity terms in the calculations. Monetary impulse refers to the change in the gap between inflation-adjusted real policy rates and neutral rates in G3 economies (the U.S., Japan and euro area). Neutral rates are estimated based on [our November 2018 paper](#), taking into account financial cycle dynamics. Fiscal impulse is defined as the change in the cyclically adjusted primary budget for G3 and China. 2020's estimated path implies mild fiscal stimulus consistent with views from the IMF, OECD and brokers, and an additional 1.0 bps of monetary easing in G3 countries. The impact of monetary easing in China is not included when calculating the fiscal impulse due to its limited influence on growth and the lack of a consistent estimate for the neutral rate.

We believe the dovish pivot by global central banks is largely behind us, and see limited prospects for a handover to fiscal stimulus.

Themes

Rethinking resilience

U.S. Treasuries maintain their ballast properties against equity market selloffs, in our view, but it is time to rethink the role of government bonds outside the U.S. Monetary policy may be reaching its limit in stoking growth – and rates in some developed markets are nearing the lowest levels that central banks can feasibly set. The pool of sovereign bonds with negative yields expanded to some \$17 trillion in 2019, according to Bloomberg data.

As bond yields fall closer to lower limits, the risk/return profile for bonds becomes increasingly asymmetric. In other words, bond prices have more room to fall than rise in response to shocks. The cushion that government bonds provide against equity market drawdowns gets thinner as yields decline. These limitations are most acute in Europe and Japan, where negative yields abound.

This has strengthened our preference for U.S. Treasuries as portfolio ballast over euro area or Japanese peers in strategic portfolios. U.S. Treasuries performed their diversification role in recent risk-off episodes such as the summer of 2019. We also see a case for substituting some nominal government bond exposures for U.S. Treasury Inflation-Protected Securities (TIPS) as a source of resilience against future inflation surprises.

A focus on sustainability can also help make portfolios more resilient, in our view, by reducing exposure to environmental, social and governance (ESG) risks.

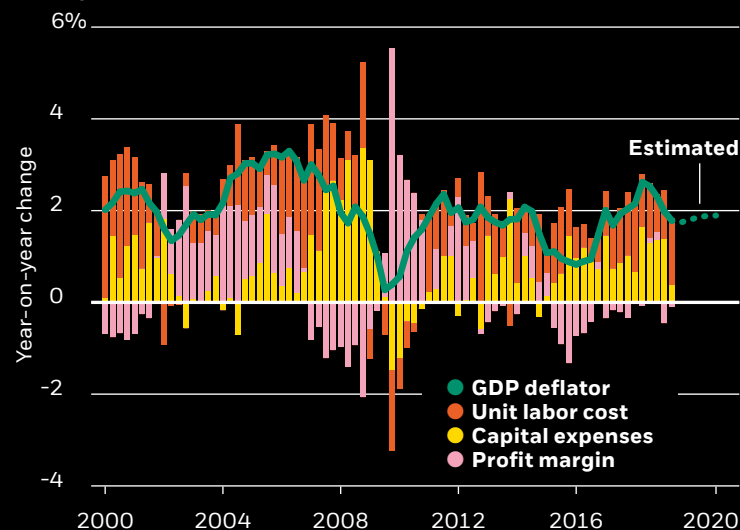
What about the tactical horizon? The risks are finely balanced in the late-cycle environment – and could trigger a shift into one of the regimes we describe on [page 7](#). They are tilted downward for growth because any renewed escalation of trade tensions could derail the growth uptick we expect. Inflation, by contrast, could surprise to the upside, particularly in the U.S. Reasons include increases in capacity utilization and tight labor markets. Wages are on the rise, as the *Pricier labor* chart shows. Over time, supply shocks could add to price pressures ([page 11](#)).

We favor the front end of the U.S. Treasury curve on a tactical basis. This segment is less vulnerable to growth- and inflation-induced steepening. TIPS can provide some resilience against both growth and underappreciated U.S. inflation risks.

We have upgraded our view on the quality style factor. Companies with quality characteristics such as strong balance sheets tend to be more resilient to late-cycle risks. At the same time, many large multinationals in the “quality” basket could benefit from a pause in trade tensions.

Pricier labor

Changes and components in U.S. GDP deflator, 2000-2020



Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis and Refinitiv, November 2019. Notes: The GDP deflator is a gauge of inflation that measures the year-on-year change in prices of all the goods and services produced in an economy. We decompose the deflator into the key drivers involved in creating each U.S. dollar of real gross domestic product (GDP), including labor costs, profit margins and capital expenses. The dotted green line is a BlackRock estimate. Forward-looking estimates may not come to pass.

Low government bond yields and underappreciated inflation risks require a rethink of the role of government bonds as portfolio ballast, especially outside the U.S.

Asset allocation

Macro regimes

The first step in our tactical asset allocation process is to systematically identify the current macro regime and think through potential regime changes. Different regimes have different implications for asset returns. We zero in on four dimensions that we see as jointly driving investment outcomes: business, policy, financial and risk. Each is determined by the interplay of two key macro variables: growth and inflation for the business cycle; monetary and fiscal policy for policy; private sector leverage and financial conditions for financial; and macro uncertainty, risk tolerance and valuations for risk.

We also identify dominant drivers such as demand and supply shocks for the business dimension, and find these have coincided with financial variables such as stock/bond correlations. Even a pared-down analysis results in a dizzying array of possible regimes, so we focus on six that have shown persistence since the 1960s: *goldilocks*, *hawkish squeeze*, *reflation*, *running hot*, *slowdown* and *stagflation*. We also include a rarer case, *recession*, that has hit markets hard.

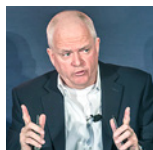
Where are we today – and what comes next? We remain in 2019's *slowdown* regime, but could see a shift into *goldilocks* if growth were to accelerate beyond our expectations and inflation to moderate.

This upside risk scenario would become more likely if trade tensions were to actually de-escalate, rather than be put on hold. A downside risk scenario: A growth undershoot and persistent inflationary pressure, potentially caused by supply shocks as a result of de-globalization, pushes the economy to *stagflation*. This is not a 1970s-like scenario of double-digit inflation, but a stubborn mix of slowing growth and upside inflation surprises. See the graphic for possible shifts.

What have returns been like in these regimes? Starting valuations matter, and that's why we took them into account when we analyzed returns since 1962. *Goldilocks* historically has seen positive returns for most assets, led by equities. Equities have held their ground in *stagflation*, with government bonds and credit suffering.

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The valuation of markets evolves through time. In the same economic regime, starting valuations matter greatly for asset returns.”



Ed Fishwick
Global Co-Head —
BlackRock's Risk and
Quantitative Analysis group

Current regime

Slowdown: Decelerating growth and inflation; rising uncertainty accompanied by monetary easing.

Our 2020 base case: Uptick in growth back to trend; no monetary easing surprises.

Potential regime shifts

Goldilocks: Growth-supportive policy with little inflationary pressure and credit expansion.

Stagflation: Slowing growth and rising inflation; contracting credit.

Other regimes

Hawkish squeeze: Decelerating growth and inflation while monetary policy is tightening.

Recession: Economic contraction with falling inflation, rising uncertainty and monetary easing.

Reflation: Supportive policy and low uncertainty; accelerating growth and inflation.

Running hot: Monetary policy tightening to limit inflation and/or financial vulnerabilities.

Source: BlackRock Investment Institute. Note: For illustrative purposes only.

We could shift into a goldilocks regime if growth were to accelerate sharply and inflation to moderate.

Asset allocation

Tactical process

Our conclusion on the dominant macro regime informs our tactical (six-to-12-month) views. The other key input: estimating the extent to which the current macro backdrop is priced into markets. This can help identify dislocations between fundamentals and market pricing, potentially leading to tactical opportunities.

This integrated view of macro fundamentals and market pricing is further informed by synthesizing technical indicators and inputs from BlackRock experts. It leads us to views on global equities, credit, government bonds and cash (page 9). We employ a similar process to arrive at more granular views of how individual assets perform against these broad asset classes and indicate different levels of conviction (page 15).

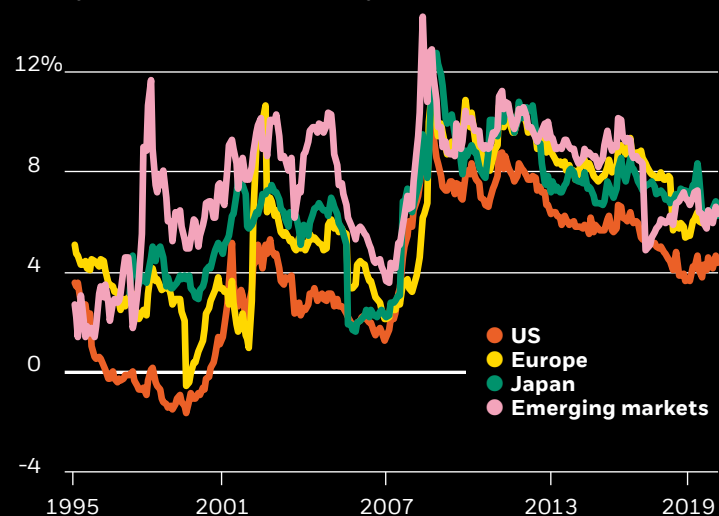
We see equity markets today as reasonably valued. Our estimate of the equity risk premium (ERP) — or the expected return of equities over the risk-free rate, shows that the ERP has been grinding lower over the post-crisis period. Yet it still looks relatively attractive in a long-term context, particularly in Japan and EMs. See the *Reasonable valuations* chart. Similarly, we believe global credit markets are reasonably priced for the macro backdrop, particularly higher-yielding segments such as EM debt.

Government bonds have cheapened after a sell-off that pushed yields higher, but we see the dovish pivot by central banks soon moving into the rear-view mirror. This leaves us neutral on duration. Overall, the expansion will likely continue, and we believe asset valuations still appear reasonable. This is why we prefer a modest tilt into risk assets, with neutral allocations to government bonds and cash. Yet we have made meaningful changes to our views within asset classes.

How about private markets? These are not suitable for all investors and are mostly for use in longer-term, strategic portfolios. We are positive but selective on these markets, both in light of our current market outlook and as investments through the cycle. Assets such as infrastructure debt and equity offer income and growth potential in the low-rate, low-growth environment, in our view, and have low correlations to other markets. Real estate looks compelling given our neutral outlook on rates, and has historically offered resilience against inflation. Lastly, we see some late-cycle risks in private equity and private credit assets. Yet we believe selected areas can be attractive relative to public markets, given the potential to gain additional returns from manager selection and taking on complexity and illiquidity risks.

Reasonable valuations

Equity risk premium across major markets, 1995-2019



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: Sept. 31, 2019. We calculate the equity risk premium based on our expectations for nominal interest rates and the earnings yields for respective equity markets. We use MSCI indexes as the proxy for the markets shown. We use BlackRock expectations for interest rates so the estimate is not influenced by the term premium in long term bond yields.

We find equities and credit are still reasonably priced, supporting our moderate pro-risk stance. We are neutral on government bonds as we see little scope for easing surprises.

Asset allocation

Directional views

Our directional views show our relative preferences across broad, global asset classes and where we think they are headed over the next six to 12-months. Three overarching ideas are embedded in these views for 2020:

Modestly positive on risk assets: The expansion of valuation multiples that powered equity markets higher in 2019 — and the dovish pivot by central banks that helped offset the downdraft from rising global trade tensions — look to be behind us. Instead, we see growth ticking up and protectionist pressures going sideways. Coupled with what appear to be reasonable valuations across equities and credit, we believe this should pave the way for modest returns in global risk assets.

Neutral on global duration and cash: Developed market policy rates look to be broadly on hold for now. With growth and inflation set to inflect higher, this creates some risk of a steepening yield curve. Short maturities and TIPS are likely to provide more resilience under this base case. They can also cushion against risks that undermine growth, such as a breakdown in U.S.-China trade talks. Our modestly pro-risk stance overall argues for a near-benchmark allocation to cash.

Cautious cyclical rotation: Cyclical assets have severely underperformed in recent years, both on a regional basis (U.S. stock market returns have outrun those of more cyclical peers) and in equity style factors (value has had a near-record stretch of lagging other factors). We believe a rebound in global trade and capex should pave the way, tactically, for stronger performance of cyclical assets such as Japanese, EM and Canadian equities. The key risks: U.S.-China trade talks break down or China fails to deliver on even modest stimulus expectations.

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.

We are moderately overweight equities and credit – and neutral on government bonds and cash.

Asset allocation

Strategic implications

Deglobalization and low yields are structural limits challenging strategic asset allocation. Deglobalization raises the risk of supply shocks that increase inflation ([page 11](#)). It also may cause a splintering of technology standards and trade patterns across regions. This argues for greater regional diversification, including to China ([page 12](#)), in our view.

Low yields and their proximity to lower bounds affect strategic allocations. Low yields strengthen the strategic case for private markets. These markets can be illiquid and are not suitable for all investors. Yet our work suggests many institutional investors are more worried than they need to be about liquidity constraints, and that owning more private assets could help them meet return and diversification goals.

The ballast properties of government bonds are being tested by their proximity to lower bounds ([page 6](#)). To illustrate, we constructed a hypothetical multi-asset strategic portfolio with a moderate risk profile, and allocations to global equities, credit and government bonds. Using the average negative stock/bond correlation since 2000, the allocation to (nominal) government bonds tops 40%.

We find this allocation would need to be halved if the stock/bond correlation were to change to zero. See the *Government bonds lose their luster* chart. In their place, we could see a greater role for inflation-linked bonds as potential portfolio stabilizers. Within a government bond allocation, we see a need to tilt toward higher-yielding U.S. Treasuries, as well as a role for Chinese government bonds.

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If government bonds won't keep a negative correlation with equities, the idea of holding them as ballast could be questioned.”



Natalie Gill
Portfolio Strategist –
BlackRock Investment
Institute

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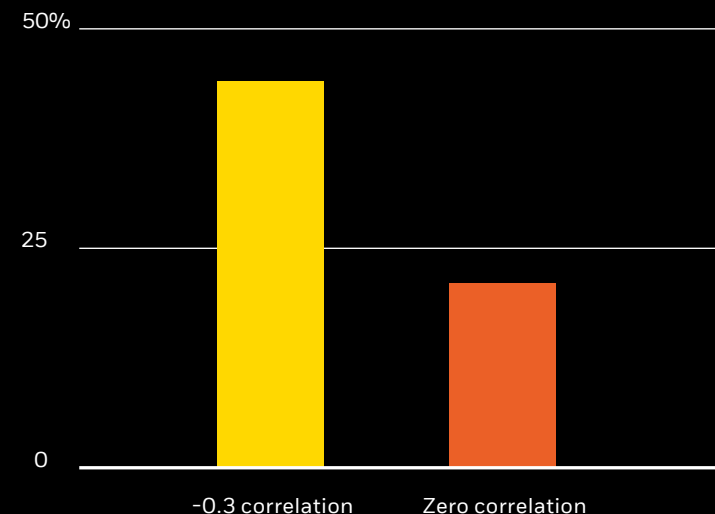
I'll bet very heavily that the limits of monetary policy innovation have not been witnessed yet.”



Bob Miller
Head of Americas
Fundamental Fixed
Income – BlackRock
Global Fixed Income

Government bonds lose their luster

Hypothetical bond allocation in different stock-bond correlations



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, December 2019. Notes: The chart shows strategic allocations to global government bonds in a hypothetical multiasset portfolio in two scenarios: 1) a correlation of -0.3 between global stock and government bond returns; 2) a correlation of zero. The base portfolio is roughly 60% bonds and 40% equities. We optimize to maximize returns for a moderate risk level. Indexes used: government bonds (Bloomberg Barclays Global Aggregate Treasuries Index), global IG credit (Bloomberg Barclays Global ex-US Credit Hedged), high yield (Bloomberg Barclays Global High Yield Index), DM equity (MSCI World Index) and EM equity (MSCI Emerging Markets Index). For illustrative purposes only. It is not possible to invest directly in an index.

The risk/return profile for bonds has become more asymmetric as yields have neared lower limits. Prices have greater room to fall than rise in response to shocks.

Forum focus

Supply shocks

This economic cycle – now entering a second decade – has been unusually long and shallow. The late-cycle, dovish pivot has also been unusual, and there are few signs of the traditional late-cycle limits of economic overheating. As a result, we don't see a slide into recession as the primary risk – but a stubborn mix of slower growth and rising inflation. The potential for such a regime shift is one reason why we prefer short-maturity U.S. Treasuries, and see inflation-linked debt as attractive. See the [pages 7-10](#) for details on other potential regime shifts and how the risks feed into our views.

Supply shocks stemming from long-term trends such as deglobalization and sustainability-related risks could prompt such a regime shift. The transition to a low-carbon world will likely require new business models, investment in sustainable infrastructure, and new regulations that may be costly. Climate change also poses physical risks to real assets. See [Getting physical](#) of April 2019.

A supply shock from deglobalization may push up input costs amid tight U.S. labor markets and rising wage growth. Tariffs already have raised U.S. core CPI. And disruption of global supply chains could reduce productivity and reinforce a slowdown in potential growth.

The protectionist push has delivered both a demand shock (the hit to sentiment) and a supply shock (reduced productive capacity as supply chains are disrupted). When supply shocks dominate, stock and bond prices often have moved in the same direction, our analysis of the U.S. business cycle since 1965 shows. See the *What a shock* chart.

The correlation between stock and bond returns was positive for much of the period through the late 1990s. A return to such a regime would be a big shift from the negative correlation that has mostly prevailed since, with bonds acting as diversifiers to equities. Looking into 2020, we're closely monitoring the dimensions of any supply shock – including through our macro regimes framework – and we detail asset allocation implications on [page 7](#).

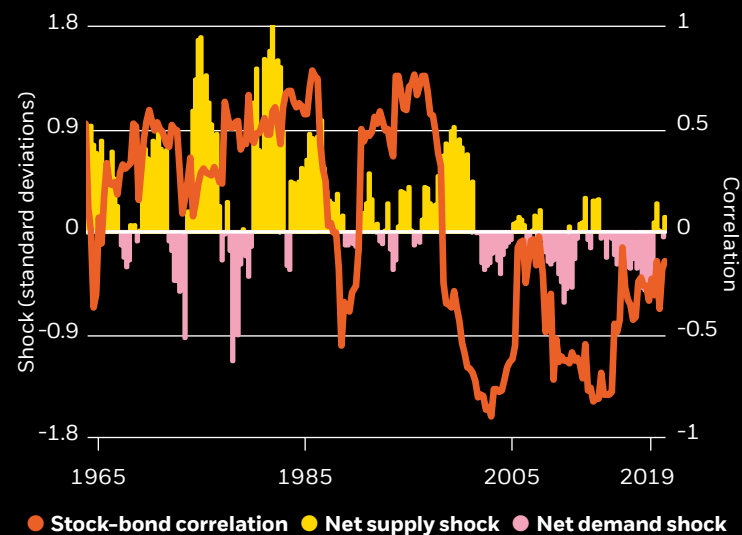
“Upward pressure on U.S. CPI will likely become more broad-based, as tariffs affect more goods.”



Sarah Foley
Senior Economist –
BlackRock Global Fixed
Income Americas

What a shock

Stock-bond correlations under different shocks, 1965-2019



Sources: BlackRock Investment Institute, November 2019. Notes: The orange line in this chart shows the correlation between quarterly U.S. stock and equity returns, on a rolling three-year basis. We use a statistical model that decomposes unexplained movements in growth and inflation into either demand or supply shocks. The bars show the absolute value of prevailing supply shocks minus the absolute value of demand shocks at each point in time. Yellow bars indicate a net supply shock; pink bars indicate net demand shocks.

The negative supply shock from deglobalization may push up input costs in an environment of tight U.S. labor markets and already rising wage growth.

Forum focus

Geopolitics

We expect market attention to geopolitical risks to remain high in 2020 even as we see U.S.-China trade tensions likely extending their temporary pause. See our [Geopolitical risk dashboard](#) and the *Politics on the mind* chart.

U.S.-China tensions remain front and center. Both sides have strong incentives to hit the pause button on trade frictions, at least through 2020 – and on balance we think that is the likeliest outcome. Yet we expect pockets of turbulence, and there has been little progress toward resolving structural U.S.-China rivalries. There is broad, bipartisan support in the U.S. to take a tough stance on China, and China looks prepared for a long struggle to gain global leadership in industries of the future. U.S. restrictions on Chinese tech giants and technology exports to China have disrupted global supply chains – and intensified China’s drive to become self-sufficient in foundational technologies. This could lead to a gradual decoupling of the U.S. and China tech sectors. Investors should consider greater exposure to China’s domestic markets over time as a result ([page 13](#)).

We see flashpoints in the fragile Middle East, including fallout from attacks on Saudi oil facilities, Turkey’s incursion into Syria and protests around the region.

Another key risk looming: a tumultuous U.S. election year. Domestic considerations will be paramount in U.S. foreign policy, including on trade. Potential economic policy outcomes are wider than they have been in decades – and uncertainty could depress business spending and market sentiment. Investors may face the risk of more disruptions to the global trade system if President Donald Trump is re-elected, or the prospect of a Democratic administration raising corporate taxes and tightening regulations. Fiscal stimulus, whether in the form of green infrastructure or tax cuts, is possible if either party gains control of both the executive and legislative branches.

Big tech companies may face a regulatory backlash whatever the election outcome, as issues around market dominance, data privacy, election meddling and cyber security rise to the fore. This challenges large caps that have led markets higher.

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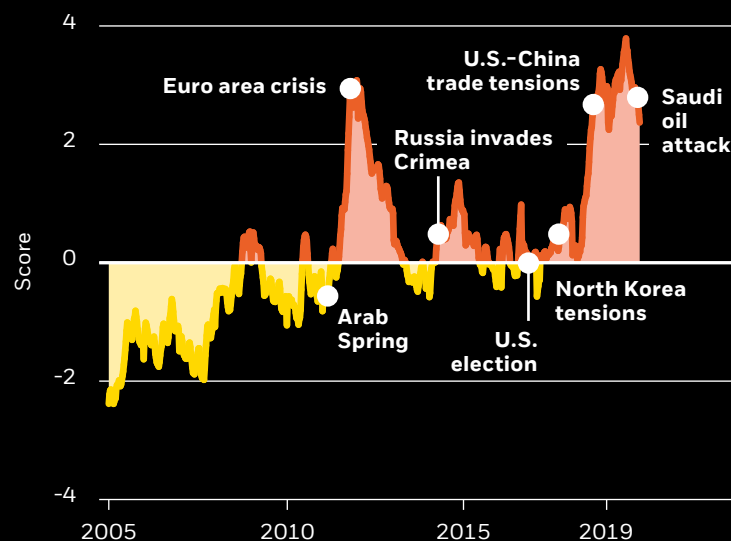
The age of self-regulation of the tech sector is coming to an end.”



Tom Donilon
Chairman – BlackRock
Investment Institute

Politics on the mind

BlackRock Geopolitical Risk Indicator – Global, 2005-2019



Source: BlackRock Investment Institute, with data from Refinitiv, November 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.

Uncertainty about the U.S. election outcome could depress sentiment. We see any temporary U.S.-China trade truce doing little to resolve structural rivalries.

Forum focus

China

China's economy is in the midst of a structural slowdown as the country transitions away from its credit-intensive growth model. China's policy stance is likely to ease further, but only incrementally. See the *Inside China's engine room* chart. We see China having diminished appetite for the type of large-scale stimulus that boosted global growth during past downturns such as 2008. It is emphasizing leaner and cleaner growth driven by consumer spending and private enterprises — over old-school infrastructure spending and support for state-owned enterprises (SOEs). The new approach fits in with Beijing's desire for currency and financial stability.

This shift won't happen overnight, and investors should expect bumps in the road. Yet China's economic rebalancing eventually could present investors with a more favorable mix: less capital flowing to lumbering SOEs with negative margins; and more to higher-quality private sector firms. And China's economy is set to generate \$1.2 trillion of incremental GDP this year, according to IMF estimates as of October, around 1.5 times the amount the U.S. is expected to add to global growth. The combination of the sheer magnitude of China's growth and its improving quality is why we see opportunities as China opens up its markets to foreign investors.

Near-term risks to China's economy, particularly surrounding frictions with the U.S., have prompted a cautious stance among global investors toward the country's assets — and some structural tensions may persist for years.

Yet there is a strategic case for owning Chinese assets. China's domestic markets are set to become a much greater share of global indexes over time. Our return expectations for Chinese stocks and bonds are at the high end of the range against global counterparts, offering return and diversification potential even after allowing for high uncertainty. Chinese stocks are volatile, but high dispersion creates potential alpha opportunities. We see rising corporate defaults as manageable — and as a sign market forces are asserting themselves.

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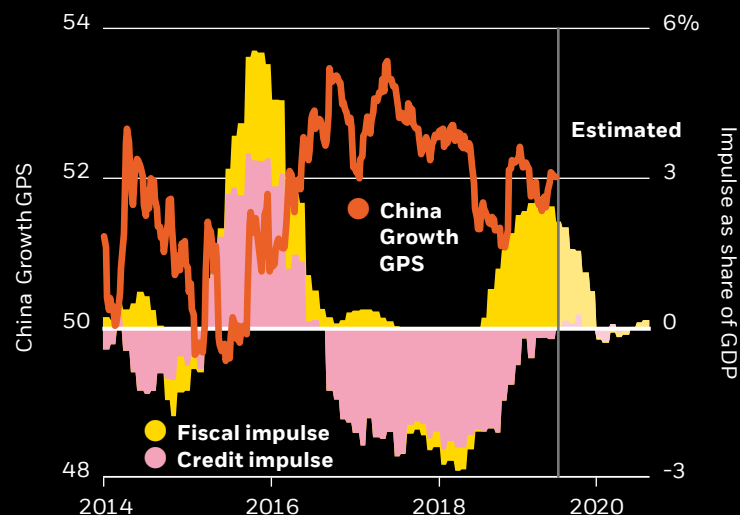
I call it the “AND” argument. China is slowing AND offers huge opportunities in its domestic markets.”



Ben Powell
Chief Investment Strategist,
APAC — BlackRock
Investment Institute

Inside China's engine room

China's credit and fiscal impulses, Growth GPS, 2014-2020



Sources: BlackRock Investment Institute, National Bureau of Statistics of China, the People's Bank of China and Consensus Economics, with data from Refinitiv Datastream, November 2019. Notes: The fiscal impulse is defined as the 12-month change in the annual fiscal deficit as a percentage of GDP. The fiscal deficit includes spending from China's general government fund. The credit impulse is defined as the 12-month change in the rate of broad credit growth as a share of GDP. We weight both the fiscal and credit impulses to reflect their respective contributions to GDP growth — as estimated in a December 2017 IMF paper. Our BlackRock GPS shows where consensus for the Caixin composite Purchasing Managers' Index forecast may stand in three months' time in China. A reading above 50 indicates an expansion; below 50 indicates contraction. Forward-looking estimates may not come to pass.

We see opportunities as China opens up its markets to foreign investors — even as overall economic growth slows.

Forum focus

Profit margins

Profit margins of publicly listed companies have been on a decades-long march higher. This has been driven by two key trends: globalization (integrated supply chains and labor markets that have, along with technological innovation, reduced input costs) and rising market concentration (the advent of superstar firms that dominate their industries).

Both now are at risk of reversal amid trade conflicts, rising wages and a regulatory backlash against winner-take-all firms. An increasing focus on sustainability poses an additional threat to some sectors, with carbon-intensive companies facing risks such as higher taxes and cost of capital. Margins also have contracted in late-cycle periods, based on our analysis of U.S. corporate profit margins over the stages of the business cycle since 1965.

This analysis — based on a broad measure of profits that includes private firms — shows margins have already fallen from peaks. See the *Profit cycle* chart. It also shows that public market profit margins tend to follow the broader measure lower with a lag of around three quarters. The problem: Consensus estimates call for corporate margins in public markets to increase in 2020. This may set markets up for a disappointment and looms as a risk to equity markets.

We still believe a moderately pro-risk stance is warranted. Equities have historically delivered returns above the full-cycle average in late-cycle periods, as detailed in our [Q2 2019 Global outlook](#). And the modest growth pick-up that we expect could support top-line growth even as corporate margins decline.

“

Understanding the sustainability of the structural uptrend in margins is critical.”



Todd Burnside
Portfolio Manager —
BlackRock U.S. Large Cap
Core Equity

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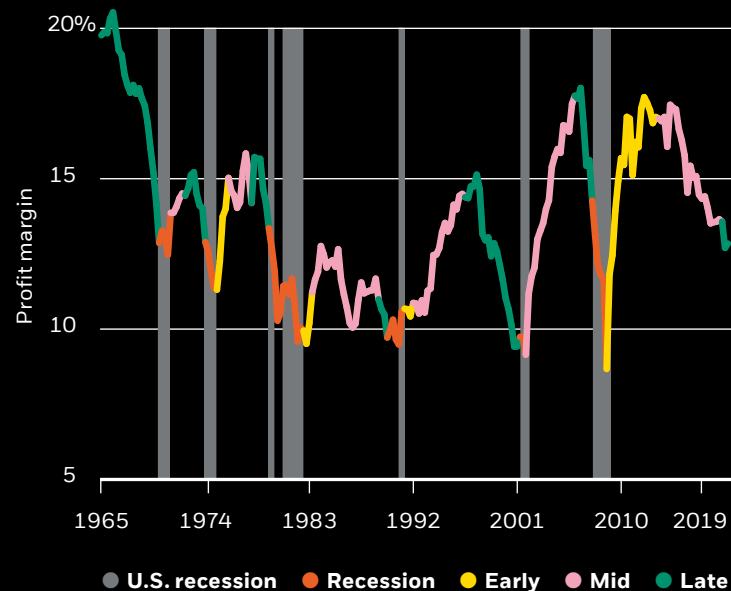
Rising wages are the biggest issue in the U.S.; in Asia and Europe, it's the lack of top-line growth.”



James Keenan
Chief Investment Officer
and Global Co-Head of
Credit — BlackRock
Alternative Investors

Profit cycle

U.S. corporate profits over the business cycle, 1965-2019

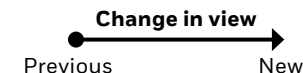


Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis (BEA), U.S. National Bureau of Economic Research (NBER) and Refinitiv, November 2019. Notes: We look at profit margins during different stages of the business cycle. The classification of the stage is done via a “cluster analysis” that groups together time periods where economic series have behaved in similar ways. These are the profit margins of U.S. corporations, in percentage points, as derived from National Income and Product Accounts data (NIPA) from the BEA.

Structural trends that have pushed up corporate profit margins for decades are at risk of reversal amid trade disputes, wage pressures and a regulatory backlash.

Granular views

Tactical views on selected assets vs. broad global asset classes by level of conviction, December 2019



Asset	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.
	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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