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BLACKROCK INVESTMENT INSTITUTE

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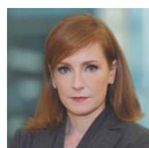

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WEEKLY COMMENTARY • JAN. 14, 2019

Key points

1 We see U.S. government bonds offering more diversification benefits in 2019 against a backdrop where economic growth is a key market driver.

2 Global equities gained, as dovish Fed minutes helped fuel further positive momentum. German economic data missed expectations. Oil rallied.

3 We see a low likelihood that the UK Parliament will pass Theresa May's Brexit deal this week in its current form. The magnitude of a defeat is key.

1 Keeping bonds as a buffer

Last year was unusual: U.S. equities and 10-year Treasuries both finished down, as heightened economic and geopolitical uncertainty and expectations for higher short-term rates drove markets. We see growth as the key market driver in 2019. This suggests Treasuries may offer more diversification benefits as a buffer to bouts of equity weakness.

Chart of the week

Correlation between U.S. equity and 10-year Treasury returns, 2004-2019

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 Thomson Reuters, January 2019. Notes: The line shows the correlation of daily returns between the MSCI USA Index (representing U.S. equities) and the benchmark 10-year U.S. Treasury over a one-year rolling period (256 trading days). The dot shows the correlation of returns over the last 90 days.

The correlation between U.S. equity and U.S. government bond returns has been negative since the early 2000s, meaning the two asset classes generally move in opposite directions. Yet the magnitude of the negative correlation varies over time. It has recently turned more negative, as shown in the chart above. We see this relationship being sustained as economic growth becomes a key driver of market returns. One corollary: bonds may offer a more formidable ballast to equity exposures. These diversification benefits were particularly evident in December, a grueling month for risk assets: U.S. equities sold off by 9.2%, while 10-year U.S. Treasury yields fell below 2.7% from around 3%, sending 10-year Treasury prices up.

Staying neutral

We see the correlation between equity and bond returns remaining significantly negative in 2019 as the economic cycle enters its latter stages. Growth, not Federal Reserve policy, is now the dominant market driver, in our view. A scenario where both U.S. stocks and 10-year Treasuries sell off, as in 2018, requires a big pickup in inflation leading to a more hawkish Fed. We see this as unlikely in 2019.

Fears of a sharp economic slowdown over the past couple of months have spurred a rally in U.S. Treasury prices and caused markets to dial down their expectations of potential Fed rate increases this year. Markets have moved from pricing in two 2019 Fed rate increases as of November to now flirting with the possibility of a rate cut. Yet market fears about economic weakness may have overshot, in our view. We see global growth slowing in 2019, and the U.S. economy entering a late-cycle phase, but view the risk of a recession this year as low. We see core inflation in the U.S. hovering near the Fed's target, and the absence of meaningful inflationary pressures giving the Fed flexibility. We expect a pause in the Fed's tightening cycle in the first half of 2019.

Against this backdrop, we maintain our neutral stance on U.S. government bonds. Increasing macro uncertainty is likely to stoke volatility in risk assets, pointing to the need for quality bonds when targeting portfolio resilience. We advocate flanking Treasury exposures with high-conviction allocations in areas that offer attractive compensation for risk, as part of our barbell approach for 2019. We would wait for a rise in yields before adding to U.S. government bond positions. One potential catalyst that could send U.S. yields higher in the short-term: an outcome from the latest U.S.-China trade negotiations that lowers trade tensions. Yet we see a full resolution of this trade dispute as unlikely in 2019 and, therefore, do not see a sustained rise in global yields this year. Also likely to suppress bond yields: We view the European Central Bank's growth estimates as optimistic, and see a 2019 rate rise from the ECB as unlikely. We do, however, see yields gradually moving higher over the medium term as policy and the yield curve eventually normalize.

2 Week in review

- Equities extended the prior week's positive momentum with a broad-based rally, as investors digested dovish Fed minutes, new fiscal stimulus in China and U.S.-China trade talks. The Fed's December meeting minutes suggested many Fed officials could take a "patient" approach on rates and see the future path of hikes as "less clear." Government bond yields rose modestly.
- German industrial production for November came in well below expectations, putting Germany on track for a potential second consecutive quarter of negative gross domestic product (GDP) growth and raising the possibility that Europe's second-largest economy is in a technical recession.
- Oil prices surged after Saudi Arabia's energy minister said the kingdom aimed to "stabilize" the oil market. China's inflation data came in lower than expected, while U.S. consumer inflation data were in line with expectations with annual core inflation at 2.2%.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.6%	3.6%	-4.3%	2.2%
U.S. Small Caps	4.8%	7.4%	-7.6%	1.5%
Non-U.S. World	3.2%	4.1%	-13.3%	3.7%
Non-U.S. Developed	2.9%	3.9%	-13.1%	3.9%
Japan	4.1%	4.0%	-14.0%	2.6%
Emerging	3.8%	3.7%	-14.3%	3.3%
Asia ex-Japan	4.1%	2.6%	-14.9%	3.0%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.3%	0.0%	1.5%	2.7%
U.S. TIPS	0.2%	0.7%	0.0%	2.8%
U.S. Investment Grade	0.3%	0.5%	-1.6%	4.2%
U.S. High Yield	1.9%	3.1%	0.3%	7.2%
U.S. Municipals	0.0%	0.3%	2.0%	2.6%
Non-U.S. Developed	0.3%	0.9%	-1.4%	0.9%
EM $ Bonds	0.7%	1.7%	-2.6%	6.6%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	6.0%	12.4%	-12.7%	$60.48
Gold	0.3%	0.6%	-2.4%	$1,290
Copper	0.4%	-0.4%	-16.8%	$5,942

Currencies	Week	YTD	12 Months	Level
Euro/USD	0.6%	0.0%	-4.7%	1.15
USD/Yen	0.0%	-1.1%	-2.5%	108.48
Pound/USD	1.0%	0.7%	-5.1%	1.28

Source: Bloomberg. As of Jan. 11, 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. Index performance is shown for illustrative purposes only. It is not possible to invest directly in an index. Past performance is not indicative of future results.

3 Week ahead

Jan. 14 China balance of trade; eurozone industrial production; fourth-quarter 2018 earnings reporting season kicks off

Jan. 15 UK Parliament vote on Brexit deal

Jan. 16 U.S. retail sales, business inventories (both could be delayed due to government shutdown)

Jan. 17 OPEC Monthly Oil Market Report; U.S. housing starts (could be delayed due to government shutdown)

Jan. 18 Japan Consumer Price Index; U.S. consumer sentiment index, industrial production

The UK Parliament is set to vote Tuesday on Prime Minister Theresa May's Brexit withdrawal deal. We see a low likelihood of the deal passing in its current form, given deep divisions within the government. May appears to be hoping that fears of a "no-deal" or a second referendum might be enough to get an amended deal through Parliament. If the vote does not pass this week, the magnitude of defeat will be important to determine the government's next move. A second referendum or a general election may yet be required to break the deadlock. See our BlackRock geopolitical risk dashboard for more on the risk of European fragmentation.

Asset class views

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

Asset class		View	Comments
Equities	U.S.	▲	Solid corporate earnings and ongoing economic expansion underpin our positive view. We have a growing preference for quality companies with strong balance sheets as the 2019 macro and earnings outlooks become more uncertain. Health care is among our favored sectors.
	Europe	▼	Weak economic momentum and political risks are challenges to earnings growth. A value bias makes Europe less attractive without a clear catalyst for value outperformance. We prefer higher-quality, globally-oriented names.
	Japan	—	We see solid corporate fundamentals and cheap valuations as supportive, but the market lacks a clear catalyst for sustained outperformance. Other positives include shareholder-friendly corporate behavior, central bank stock buying and political stability.
	EM	▲	Attractive valuations, coupled with a backdrop of economic reforms and policy stimulus, support the case for EM stocks. We view financial contagion risks as low. Uncertainty around trade is likely to persist, though much has been priced in. 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	—	U.S. Treasuries are an attractive offset to equity risk, particularly as U.S. interest rates near neutral and upward rate pressure eases. Weakening economic fundamentals and a slowdown in Fed normalization would support Treasuries. We see reasonable value in mortgages. Inflation-linked debt has cheapened, but we see no obvious catalyst for outperformance.
	U.S. municipals	—	Solid demand for munis as a tax shelter and expectations for muted issuance should support the asset class. We prefer a long duration stance, expressed via a barbell strategy focused on two- and 20-year maturities.
	U.S. credit	—	Solid fundamentals support credit markets, but late-cycle economic concerns pose a risk to valuations. We favor an up-in-quality stance with a preference for investment grade credit. We hold a balanced view between high yield bonds and loans.
	European sovereigns	▼	Yields are relatively unattractive and vulnerable to any growth uptick. Rising rate differentials have made European sovereigns more appealing for global investors with currency hedges. Italian spreads reflect quite a bit of risk.
	European credit	—	Valuations are attractive, particularly on a hedged basis for U.S. dollar investors. We see opportunities in industrials but are cautious on other cyclical sectors. We favor senior financial debt that would stand to benefit from any new ECB support, over subordinated financials. We prefer European over UK credit on Brexit risks. Political uncertainty is a concern.
	EM debt	—	We prefer hard-currency over local-currency debt and developed market corporate bonds. Slowing supply and broadly strong EM fundamentals add to the relative appeal of hard-currency EM debt. Trade conflicts and a tightening of global financial conditions call for a selective approach.
	Asia fixed income	—	Stable fundamentals, cheapening valuations and slowing issuance are supportive. China's representation in the region's bond universe is rising. Higher-quality growth and a focus on financial sector reform are long-term positives, but a sharp China growth slowdown would be a challenge.
Other	Commodities and currencies	*	A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could signal upside to industrial metal prices. We are neutral on the U.S. dollar. It maintains "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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