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Key points

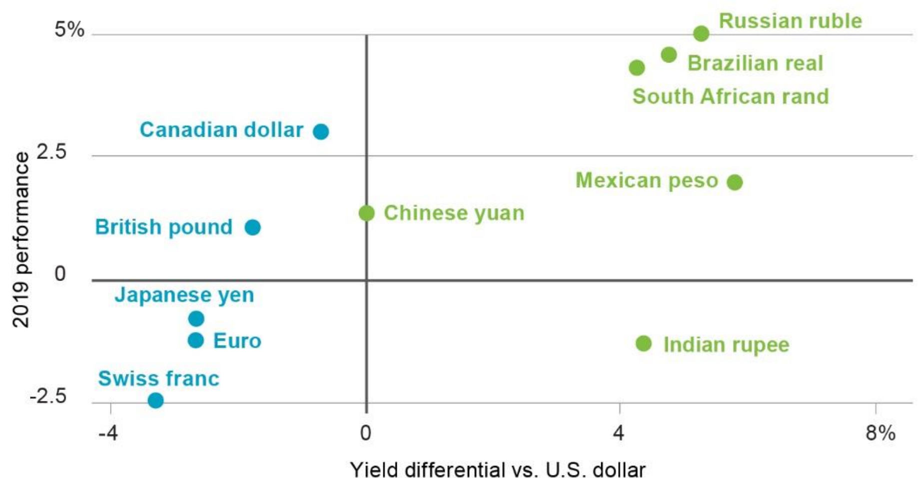
1. We see room for ongoing U.S. dollar strength versus most developed market peers and further depreciation against EM currencies.
2. Global stocks rose on hopes of progress in U.S.-China trade talks. Lower oil output in January pushed oil prices to a three-month high.
3. The Federal Reserve's latest policy meeting minutes due this week could offer insight on the Fed's "patient" approach.

1 Two sides to the U.S. dollar story

Where is the U.S. dollar headed after its sizable appreciation in 2018? It depends on your vantage point. The dollar has gained against most developed market (DM) currencies, but depreciated against emerging market (EM) counterparts so far this year. We see this trend as likely to run on in the short term in the absence of policy surprises.

Chart of the week

Yield differentials and year-to-date currency performance vs. U.S. dollar



Sources: BlackRock Investment Institute, with data from Bloomberg and Thomson Reuters, as of February 2019. Notes: We use two-year government bond yields as a proxy for currency yields. Currency yield differentials are the differences between the government bond yields of the country that issues a certain currency and those in the U.S. The currency yield of the euro is represented by the average two-year government bond yield of Germany, Italy and France. Performance shown is as of Feb. 13, 2019, and represented by the change in each currency's exchange rate against the dollar. Blue indicates developed markets and green emerging markets.

The dollar's resilience this year has come as a surprise to some. A combination of rising risk appetite, slowing U.S. growth and a Fed taking a pause in its monetary tightening would typically weigh on the greenback. Yet the same factors keeping the Fed on hold – slowing global growth and tightening financial conditions – are pushing other central banks toward a more dovish stance. This has helped the dollar retain its status as the highest-yielding DM currency and supported its modest gains this year. Most high-yielding EM currencies have also outperformed, as the chart shows. Yet interest rate differentials are not the only driver of currencies. The British pound's fate is linked more to Brexit developments. And rising oil prices and risk appetite have helped the Canadian dollar's performance so far this year.

What does a stable dollar mean?

The dollar's yield advantage – the highest since early 2018 against a trade-weighted basket of G10 currencies – has led to a revival of the "carry trade." Investors are borrowing in lower-yielding currencies such as the euro or Japanese yen, investing in higher yielders like the dollar and EM currencies, and pocketing the difference in yield (some of that "carry" is lost for investors hedging their dollar exposure). We see this trend as a key driver of currency movements in the short run – as the Fed appears likely to hold off on rate increases at least through the first half of the year, and other DM central banks are also expected to stay dovish.

A more stable dollar, coupled with a slowing but still growing global economy, underpins our positive view on EM assets. For one, it removes a key risk for emerging market economies with large external debt burdens. As many EM debtors borrow in dollars, a stronger greenback raises their borrowing costs – and tightens EM financial conditions. A more stable dollar also reduces the danger of taking on EM currency exposure, historically a large source of volatility for investors in local-currency EM debt. This underlies our recent call for a balanced approach to EMD, taking risk in both local- and hard-currency debt. We see both as attractive sources of income and are overweight EM equities. EM assets in general tend to perform well when EM currencies are rising. Risks to our positive EM views: an earlier-than-expected resumption of Fed tightening and the renewed dollar strength that would follow suit.

Bottom line: We see the dollar holding its gains against most DM peers and underperforming EM currencies in the short term. Uncertainties in global growth and geopolitics cloud the longer-term picture. The dollar's perceived "safe haven" role is likely to boost the greenback in the event of any return of recession fears or a resurgence in geopolitical risk. The dollar's relatively high valuation may limit its upside in the long term. The real effective exchange rate – a key trade-weighted gauge of the dollar's value – is sitting roughly one standard deviation above the 20-year average.

2 Week in review

- Global stocks gained on hopes on the ongoing U.S.-China trade talks. The VIX index, a gauge of U.S. stock market volatility, fell to a four-month low. A drop in January's oil output as reported by the International Energy Agency helped send oil prices to three-month highs. U.S. President Donald Trump signed a spending bill to avert a second partial government shutdown in two months.
- Companies representing two-thirds of global stock market value have reported earnings, with single-digit annual growth in profits and sales. Over 70% of technology companies beat expectations, and energy sector earnings were surprisingly strong despite a sharp drop in oil prices in the last quarter of 2018. Japanese corporate earnings fell partly due to weakness in Chinese demand.
- U.S. economic data sent mixed messages. The December core consumer price index (CPI), which excludes volatile food and energy prices, beat expectations, coming in at 2.2%. But retail sales recorded their sharpest decline in more than nine years, suggesting a slowdown in economic activity that will likely be reflected in fourth-quarter gross domestic product (GDP).

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	2.6%	11.0%	3.7%	2.0%
U.S. Small Caps	4.2%	16.5%	3.5%	1.6%
Non-U.S. World	1.3%	7.5%	-8.2%	3.3%
Non-U.S. Developed	2.0%	7.2%	-7.6%	3.5%
Japan	1.7%	4.9%	-9.2%	2.5%
Emerging	-0.5%	6.8%	-11.8%	2.8%
Asia ex-Japan	-0.3%	6.7%	-10.3%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	-0.2%	0.4%	3.6%	2.7%
U.S. TIPS	0.1%	1.2%	2.0%	2.8%
U.S. Investment Grade	0.0%	2.6%	2.8%	3.9%
U.S. High Yield	0.6%	5.4%	4.0%	6.7%
U.S. Municipals	0.0%	1.0%	3.9%	2.6%
Non-U.S. Developed	-0.6%	0.3%	-5.0%	0.9%
EM $ Bonds	0.1%	4.5%	2.8%	6.3%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	6.7%	23.1%	3.0%	$ 66.25
Gold	0.6%	3.0%	-2.3%	$ 1,321
Copper	-0.4%	3.7%	-13.8%	$ 6,188

Currencies	Week	YTD	12 Months	Level
Euro/USD	-0.3%	-1.5%	-9.7%	1.13
USD/Yen	0.7%	0.8%	4.1%	110.50
Pound/USD	-0.4%	1.0%	-8.6%	1.29

Source: Thomson Reuters. As of Feb. 15, 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

Feb. 19	Germany's ZEW Indicator of Economic Sentiment	**Feb. 21**	U.S. durable goods; Germany, France, U.S., eurozone Purchasing Managers' Indexes (PMI)
Feb. 20	Federal Open Market Committee (FOMC) Jan. 29-30 meeting minutes; eurozone business and consumer sentiment	**Feb. 22**	German IFO Business Climate Index

The January FOMC minutes may shed more light on what the central bank's recently adopted "patient" approach to its monetary policy means. Any hint that the Fed may still be looking to raise rates this year could spook the market. Fed funds futures currently indicate investors expect no rate changes for the whole of 2019. We expect the Fed to pause on any rate moves for at least the first half.

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	—	A negative correlation with risk assets makes Treasuries attractive portfolio diversifiers. We see modestly soft economic news, positive fixed income flows and a first-half pause in Fed rate hikes as supportive. The impact of Fed balance sheet reduction should be muted. The front end has the most appealing risk-adjusted income, but we favor going out on the curve on any material backup in yields.
	U.S. municipals	—	We prefer long-intermediate maturities for their attractive carry amid a steeper yield curve. We see supply-demand dynamics supporting the asset class in the near term as we expect new issuance to lag the total amount of debt that is called, refunded or matures.
	U.S. credit	—	Solid fundamentals are supportive, but late-cycle economic concerns pose a risk to valuations. We favor BBB-rated bonds in the investment grade space and emphasize credit selection. We generally see healthy fundamentals, supportive supply-demand and valuations in high yield, and prefer bonds over loans.
	European sovereigns	▼	We steer away from most euro peripheral debt amid rising political risks, slowing economic momentum and fewer policy levers to counter any downturn. We see a no-deal Brexit as unlikely, but expect a bumpy road. We favor the British pound and underweight UK gilts in the medium term as a result.
	European credit	—	We are overall cautious on euro investment grade credit — but see attractive relative value and income potential in the BBB segment. Yields compare favorably when hedged back to the U.S. dollar. We are neutral on European high yield but note significantly wider credit spreads versus equivalent U.S. peers.
	EM debt	—	Valuations are attractive despite the recent rally, and limited issuance in recent months is supportive. A pause in U.S. monetary policy tightening and U.S. dollar strength remove a key drag on performance. Clear risks include deteriorating U.S.-China relations and slower global growth.
	Asia fixed income	—	Easing U.S.-China trade tensions would increase the appeal of the Chinese yuan. A focus on quality is prudent in credit. We favor investment grade in India, China and parts of the Middle East, and high yield in Indonesia and in Chinese real estate.
Other	Commodities and currencies	*	We see oil prices underpinned by the effort of major oil-producing countries to eliminate global oil oversupply. Any relaxation in trade tensions could signal upside to industrial metal prices. We see the U.S. dollar's outlook as balanced. We prefer the dollar among developed market peers and could see it weakening further against high-yielding EM currencies.

▲ Overweight — Neutral ▼ Underweight

*Given the breadth of this category, we do not offer a consolidated view.

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