# Weekly commentary

BlackRock

April 20, 2020

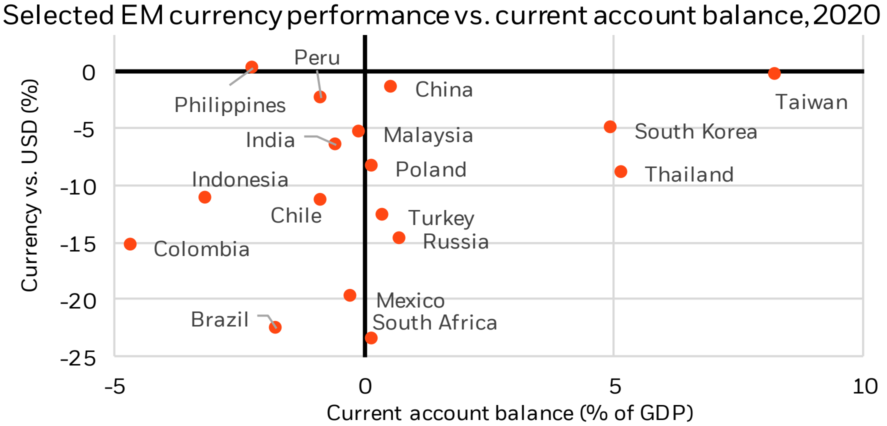
## Downgrading EM local debt

- We downgrade emerging market (EM) local debt to neutral on currency concerns, but still like Asia ex-Japan equities and credit.
- U.S. stocks extended gains, brushing off poor economic data including a collapse in retail sales and China's GDP contraction.
- This week's euro area data will help gauge the impact from the containment measures on consumer and business sentiment.

We have turned more cautious on emerging market (EM) local debt despite depressed valuations after recent selloffs. Some EMs have allowed their currencies to weaken to help absorb the economic shock, and we see a risk of further currency declines in selected EMs that could wipe out coupon income. We are still overweight equities and credit in Asia ex-Japan, with China gradually restarting its economy and readying more policy support.

### Chart of the week

Selected EM currency performance vs. current account balance, 2020




Sources: BlackRock Investment Institute, with data from Refinitiv and IMF, April 2020. Notes: The Dots show the IMF estimate of the current account balance as a share of GDP for the current year (on the horizontal axis) and the change in spot currency exchange rate against the U.S. dollar so far in 2020 (on the vertical axis).

Emerging economies are different in economic fundamentals, fiscal conditions, governing capabilities – and the quality of public health systems. Compare key metrics on our interactive Emerging markets marker. Many EMs have seen their currencies falling sharply against the U.S. dollar, especially the South African rand and Brazilian real. See the chart above. This follows a pattern seen in past crises, when countries with the greatest external vulnerabilities (current account deficits) have often taken the biggest hit to their exchange rates. One difference from previous crisis periods: Many emerging economies today are not fighting currency declines, which act as economic relief valves that can increase export competitiveness and shrink current account deficits over time. Instead, they are easing monetary and fiscal policies. This comes with risks. Potential capital flight could exacerbate currency declines and force some EM central banks to reverse course and raise rates.

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It is not all bad news for emerging markets. We see the Federal Reserve's recent flurry of emergency policy actions – as well as those of other major central banks – as supportive of fixed income markets globally. The Fed's moves aim to ease financial conditions and provide ample U.S. dollar liquidity. Among them: cutting interest rates to near zero, purchasing investment grade and high yield bonds, and providing dollar liquidity to more foreign central banks via dollar swap lines. We see the liquidity in developed markets spilling over to the EM world. As yields compress in DM credit, many investors will likely seek out alternative sources of coupon income such as higher-quality EM debt. Another potential positive: China is gradually restarting its economy after stringent lockdown measures, and is set to deliver a large stimulus package. A rebound in China's economic activity could bode well for EM exporters of bulk commodities in particular.

Yet we worry about the ability of many emerging economies to weather a growth shock that is set to exceed that of the global financial crisis in magnitude. EM activity was the first to plummet, led by China. Economists now see growth modestly contracting in the EM world for 2020, with risks skewed to the downside. The coronavirus outbreak threatens to overburden weak public health systems in many emerging economies, leading to the prospect of prolonged economic damage. International lenders of last resort such as the International Monetary Fund have signaled a willingness to step in aggressively to aid EMs in financial distress. This will help plug significant funding gaps and liquidity shortages, but such help typically comes with strings attached such as potential debt write-downs.

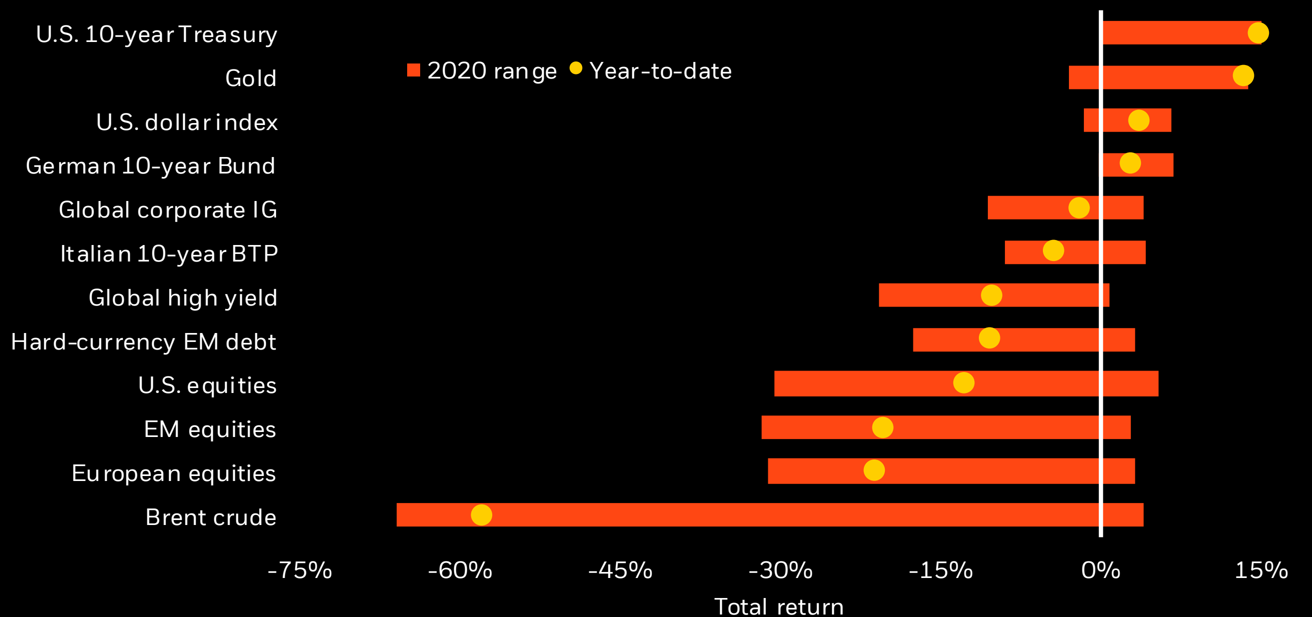
The bottom line: We downgrade EM local debt to neutral given risks of further currency depreciation and keep hard-currency EM at neutral. Overall, we see a place for income sources such as EM debt in a world where yield is hard to come by, but favor global investment grade and high yield credit at this point. We remain neutral on EM equities, as outperformance is more contingent on a growth recovery than it is in credit. We overweight Asia ex-Japan equities, which we see leading such a recovery as China slowly reopens its economy. We generally prefer credit over equities given bondholders' preferential claim on corporate cash flows in a highly uncertain economic environment.

# Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the key is policy execution to ensure households and businesses get the cash being promised. Provided such actions are effective, we believe the cumulative loss in economic output over time from this shock may ultimately be less than that of the 2008 financial crisis. See How large is the coronavirus macro shock for more. China's economy contracted for the first time on record in the first quarter, but U.S. stocks extended gains into a second week, on hopes that economic reopening was near.

## Assets in review

Selected asset performance, 2020 year-to-date and range



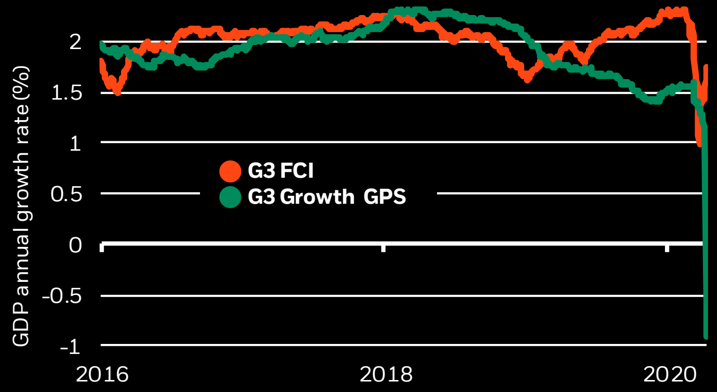

**Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, 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.

# Macro insights

Global central banks have helped alleviate the dysfunction of market pricing and tightening of financial conditions. The Fed's recent array of support measures, including the Main Street financing, corporate bond municipal bond facilities, showed yet again how a central bank can use its balance sheet in new ways to support the economy. The signpost on policy is now about execution and delivery. There are difficulties in the U.S. in getting money out the door to households and business, and other countries are having trouble rolling out jobless benefits and bridging loans to small businesses. The market – for now – appears willing to give a pass on the execution, focus on the potential plateauing of coronavirus cases and hope for an economic recovery. But overcoming these execution challenges will be crucial in months ahead. We now need to see the policy support delivered and implemented in a timely way to limit the risk of permanent economic damage, as we discuss in How large is the coronavirus macro shock?

## Tighter times

The BlackRock G3 FCI and G3 Growth GPS, 2016-2020




Sources: BlackRock Investment Institute and Bloomberg, April 2020. 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. The BlackRock Growth GPS (green line) 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. Forward-looking estimates may not come to pass.

# Investment themes

## 1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 - but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions as stringent shutdown measures take effect. A key question: Can such measures be lifted without a major second wave of cases?
- The nature of the rebound will depend on the path of the outbreak, effective delivery of policy response and potential changes to consumer and corporate behaviors.
- The U.S. will likely prove more resilient than many other developed economies because of a smaller share of manufacturing in its GDP, a relatively high share of healthcare spending and an aggressive policy response.
- **Market implication**: We are mostly sticking to benchmark holdings on an asset class level; prefer credit over equities; and favor rebalancing into the risk asset decline.

## 2 Bold policy action

- We believe the required policy response includes drastic public health measures to stem the outbreak. A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets is taking shape, particularly in the U.S. The key: policies to forestall any cash flow crunches among small businesses and households that could lead to financial stresses and tip the economy into a crisis.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the coronavirus shock, announcing $2.3 trillion in new lending support to small business payrolls and local governments. U.S. policymakers are looking to add to the already passed $2 trillion fiscal support package to help small businesses.
- Euro area finance ministers look set to launch an array of measures providing broad support along similar lines – potentially including use of the European Stability Mechanism. Successful policy implementation is key now. Japan passed fresh stimulus taking its fiscal spending plans to about 10% of GDP.
- Some actions are raising questions about whether they may undermine the independence of central banks. The UK Treasury activated a funding facility for spending that will be directly financed by the Bank of England, rather than the gilt market, but called the move temporary.
- It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central bank policy has moved from mostly alleviating the dysfunction of market pricing and tightening of financial conditions to ensuring credit flows to businesses and local governments.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit and dividend income in selected equity sectors.

## 3 Resilience rules

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds. The recent bounce in Treasury yields off record lows illustrates the risk of snapbacks.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a new phenomenon that will carry a return advantage over years and decades.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

# Week ahead

| | |
|---|---|
| **Apr. 21** | German ZEW indicator of economic sentiment |
| **Apr. 22** | Euro area flash consumer confidence |
| **Apr. 23** | Flash purchasing managers' index (PMI) for the U.S., UK and euro area |
| **Apr. 24** | Ifo Business Climate Index |

The spate of data from the euro area this week could help markets gauge the impact of containment measures on the economic, business sand consumer sentiment.

# Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, April 2020

| Asset | Underweight / Neutral / Overweight |
|---|---|
| **Equities** | We previously downgraded global equities to neutral. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room. We favor rebalancing back toward benchmark weights as markets fall. |
| **Credit** | We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield. |
| **Government bonds** | We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels. |
| **Cash** | We maintain our neutral position on cash for risk mitigation. 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.

# Granular views

Change in view
Previous → New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 2020

| | Asset | Underweight | Overweight | |
|---|---|---|---|---|
| Equities | United States | | ■ | We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning. |
| Equities | Euro area | ■ | | We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade. |
| Equities | Japan | ■ | | We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact. |
| Equities | Emerging markets | | | We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems. |
| Equities | Asia ex-Japan | | ■ | We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity. |
| Equities | Momentum | | | We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies. |
| Equities | Value | ■ | | We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy. |
| Equities | Minimum volatility | | ■ | We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle. |
| Equities | Quality | | ■ | We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations. |
| Fixed Income | U.S. Treasuries | | ■ | We like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets. |
| Fixed Income | Treasury Inflation-Protected Securities | | | We are neutral on TIPS. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations. |
| Fixed Income | German bunds | ■ | | We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries. |
| Fixed Income | Euro area peripherals | | ■ | We like euro area peripheral government bonds. Renewed asset purchases by the European Central Bank are a major support, and valuations have cheapened. |
| Fixed Income | Global investment grade | | ■ | We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened. |
| Fixed Income | Global high yield | | ■ | We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities. |
| Fixed Income | Emerging market – hard currency | | | We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced. |
| Fixed Income | Emerging market – local currency | | | We have downgraded local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon income. |
| Fixed Income | Asia fixed income | | ■ | We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors. |

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