December 2019

BlackRock

Global Outlook – Testing limits

BlackRock
Investment
Institute

Our 2020 investment themes

Growth edges up – We see an inflection point as global economic growth edges higher in 2020 thanks to easy financial conditions, limiting recession risks. 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 the potential for cyclical assets like Japanese and emerging market (EM) equities 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.

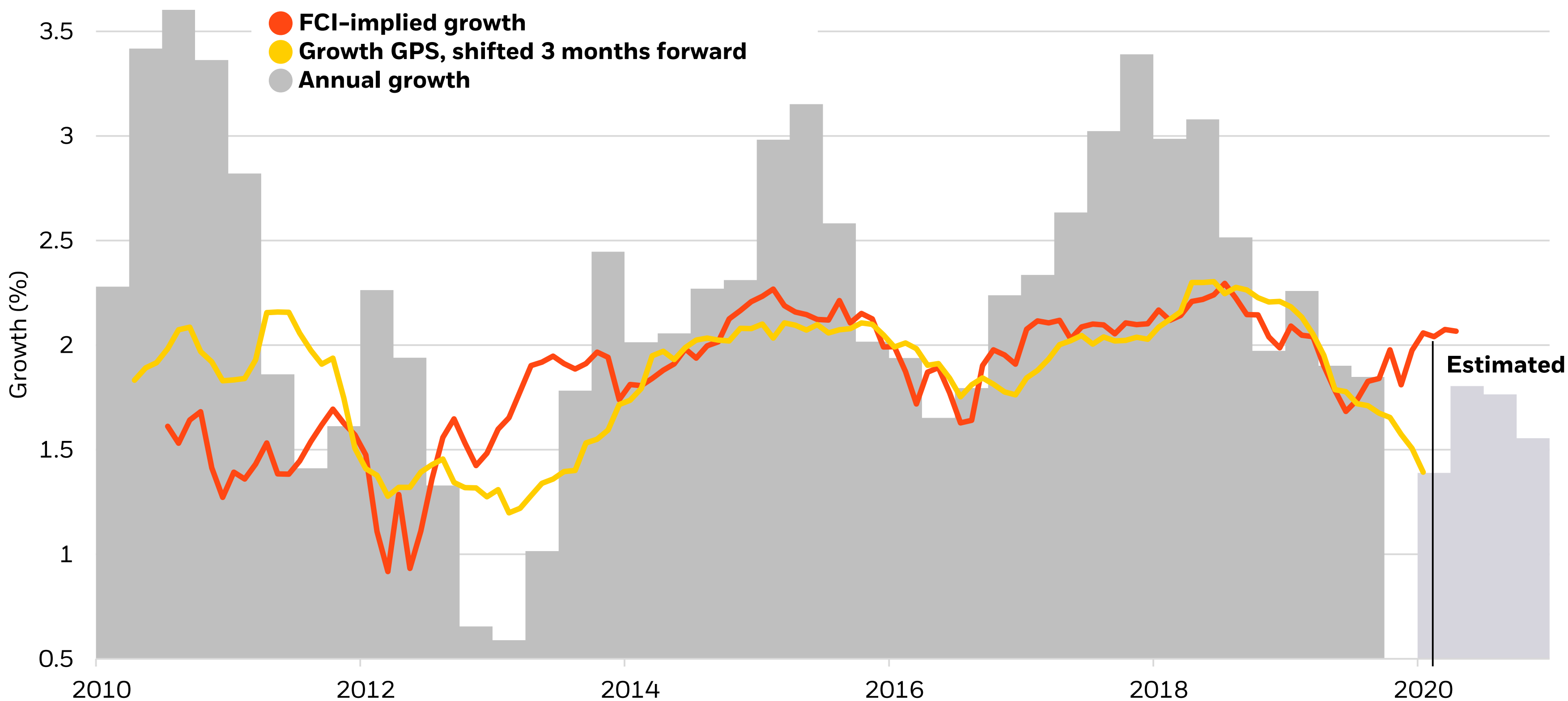
Rethinking resilience – Yields are testing lower limits in many developed markets, making many government bonds less effective portfolio ballast in case of equity market selloffs. A focus on sustainability can also help add resilience to portfolios as markets wake up to environmental, social and governance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

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

Easy financial conditions should translate into growth

We see growth led by a recovery in global manufacturing and interest rate-sensitive sectors. Underappreciated risks around higher inflation temper our overall pro-risk stance.

BlackRock G3 FCI and Growth GPS, 2010–2020

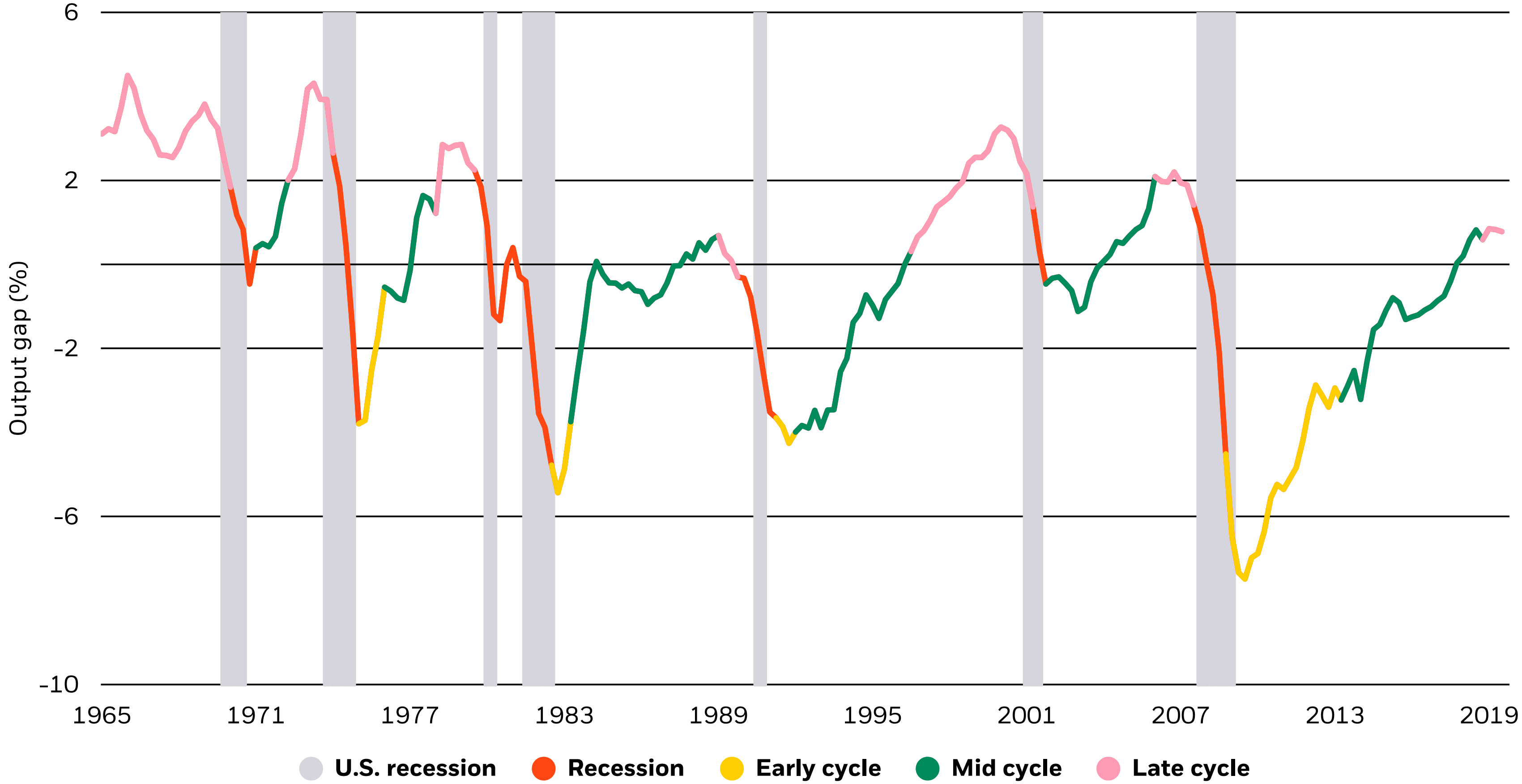


Sources: BlackRock Investment Institute, Consensus Economics and Reuters polls, December 2019. Notes: The Growth GPS shows where consensus GDP forecast may stand in three months' time, shifted forward by three months. The orange line shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS, shifted forward by six months. The grey area shows 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.

The U.S. economic expansion is intact

We see a limited pickup that pushes the economy back to the late-cycle norm of trend-like growth. The record-long U.S. economic expansion is underpinned by healthy household spending.

Output gap and stages of the U.S. business cycle, 1965-2019

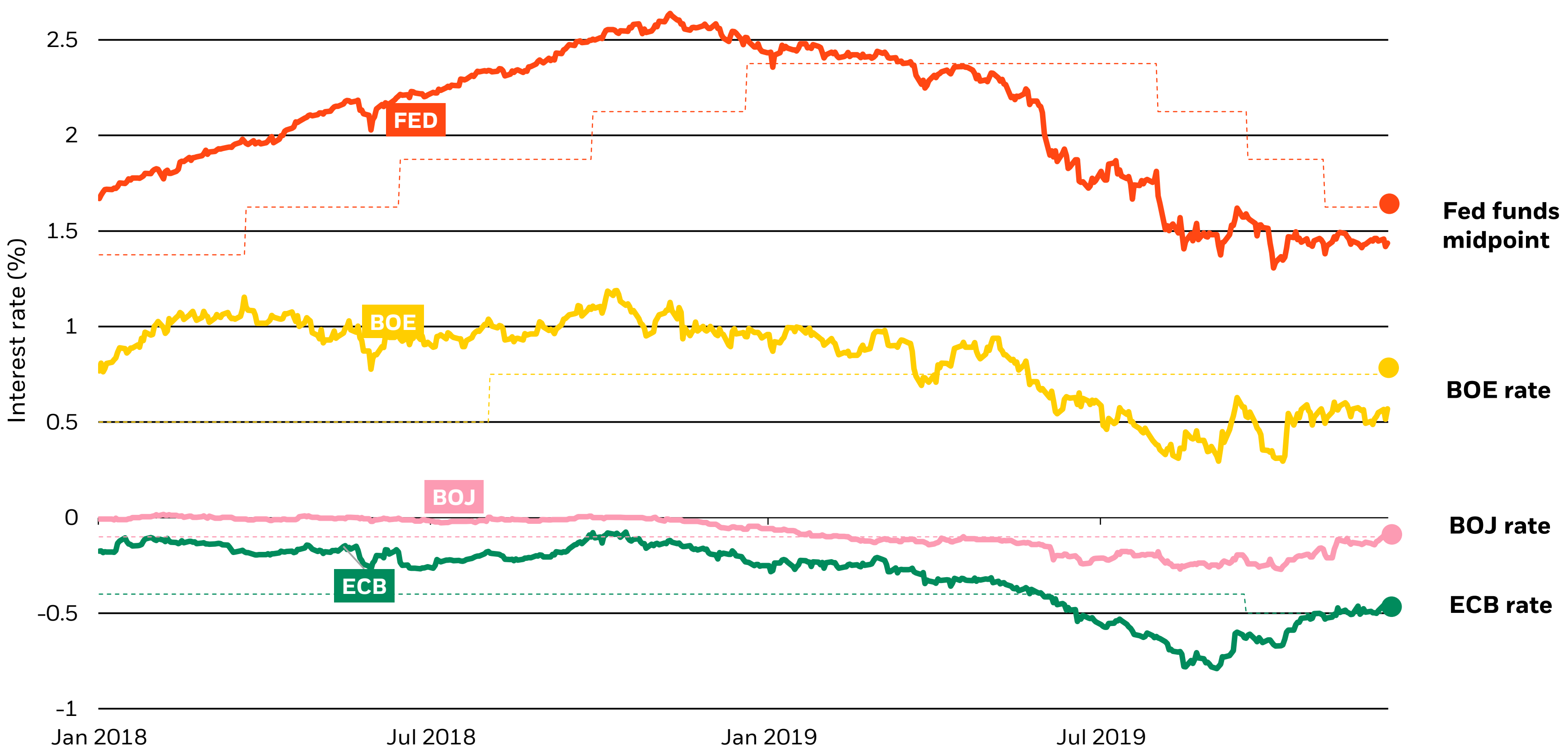


Sources: BlackRock Investment Institute and National Bureau of Economic Research, with data from Refinitiv Datastream, as of December 2019. Notes: This chart shows an estimate of the U.S. output gap (GDP as a percentage of potential GDP). We have classified different time periods as belonging to certain 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.

Central banks' dovish pivot has likely run its course

We see the current policy setting supportive of growth yet don't see monetary policy as a 2020 story. Emerging markets still have room to provide stimulus, but the U.S. dovish pivot is over for now.

Central bank policy rates and 1-year/1-year forwards, 2018-2019



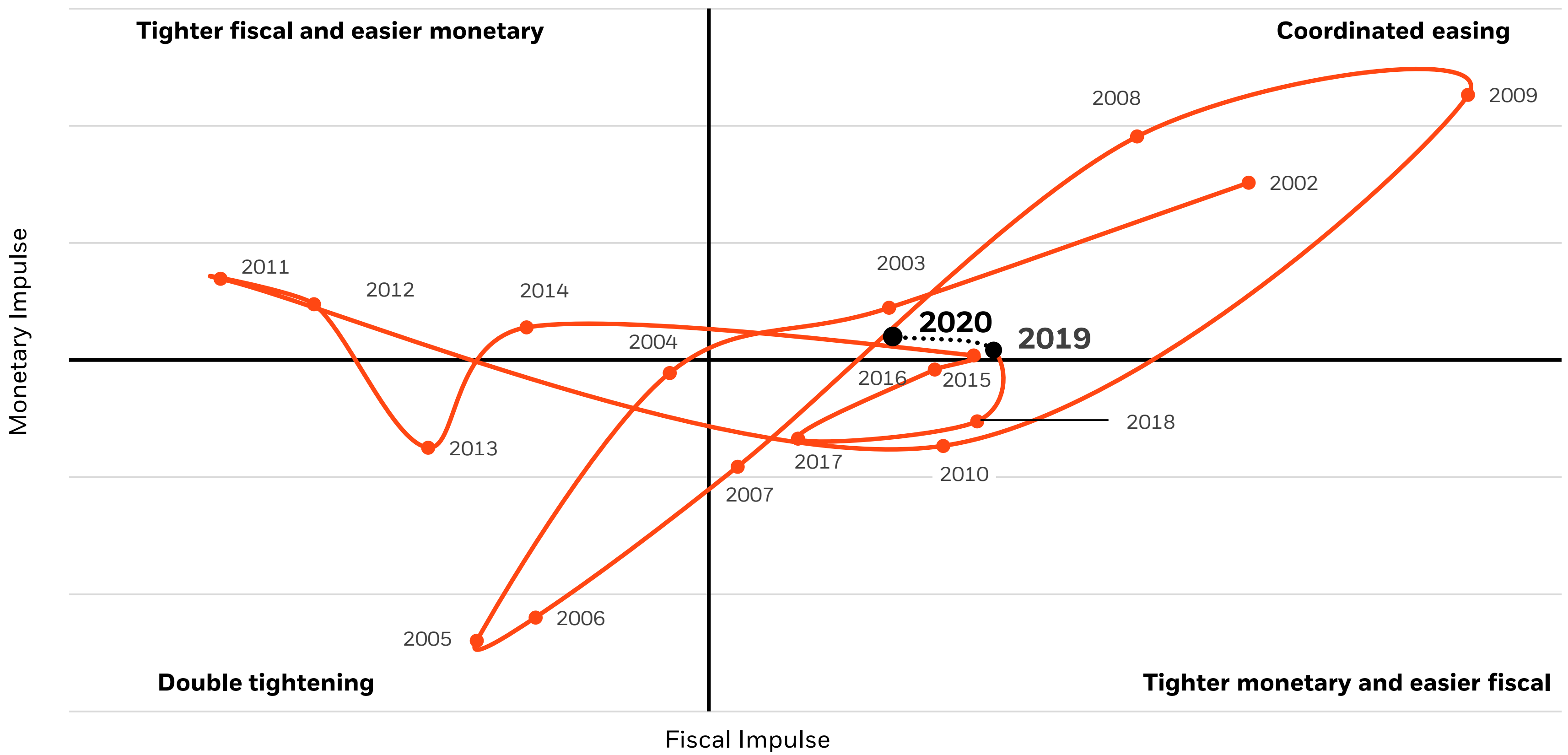
There is no guarantee that any forecasts made will come to pass. Past performance is no guarantee of future results.

Source: BlackRock Investment Institute with data from Bloomberg, December 2019. Data as of 4th December 2019. Notes: The chart shows the market pricing of policy rates in overnight index swaps on a one-year horizon starting in one year's time. Dotted lines show policy rates for each region; we use the midpoint of the Fed funds target range for the U.S.

Moving the wrong way

The policy debate is poised to shift from monetary to fiscal stimulus.
On current projections, the policy outlook appears limited. Yet risk to fiscal support is on the upside.

Monetary and fiscal impulse in G3 plus China, 2002–2020

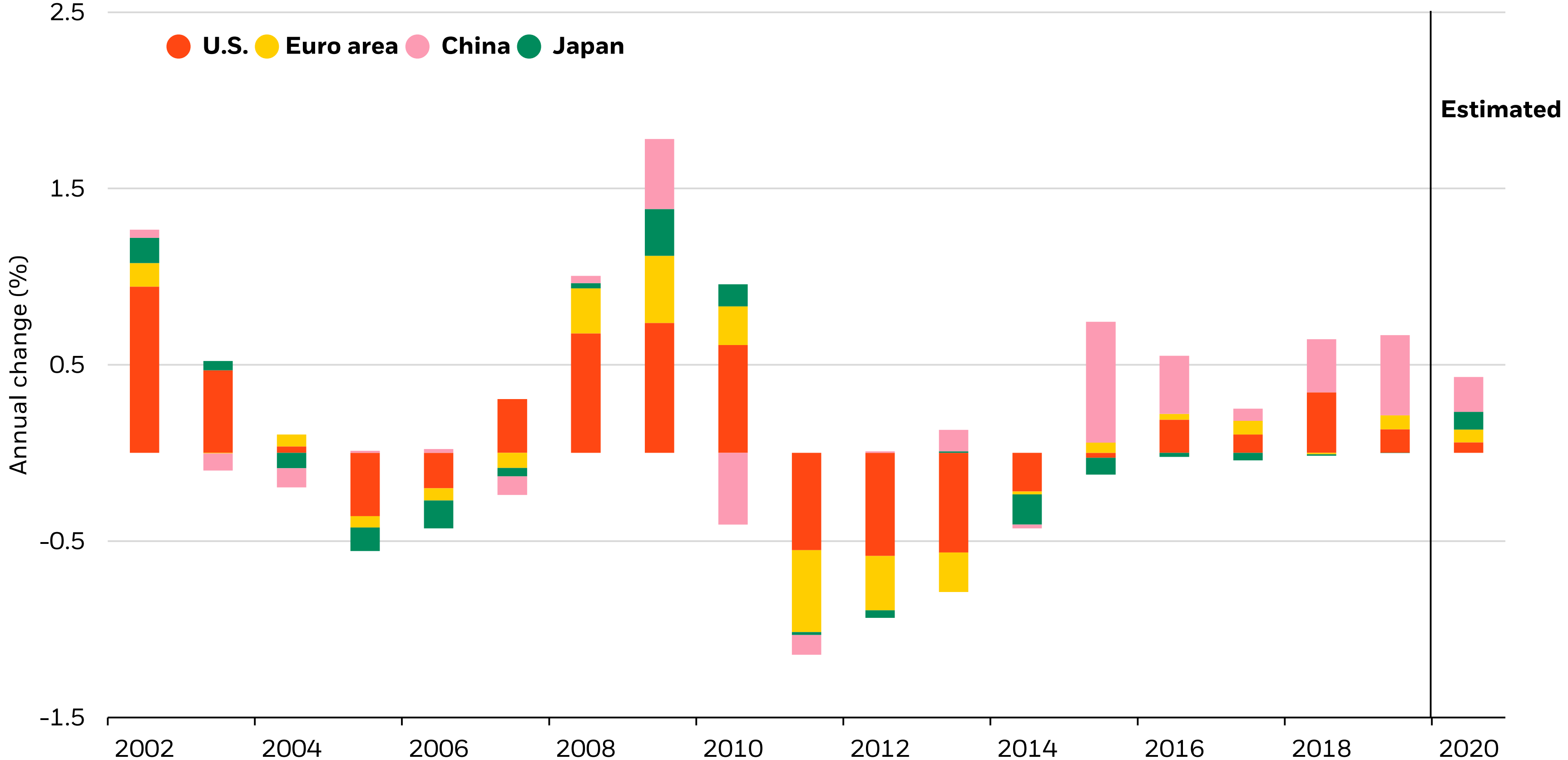


Sources: BlackRock Investment Institute, with data from the IMF, OECD and Refinitiv Datastream, December 2019. Notes: We use weights based on GDP in purchasing power parity terms in the calculations. Monetary impulse refers to the change in the gap between inflation-adjusted real policy rates and neutral 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 10 bps monetary easing in G3 countries. The impact of monetary easing in China is not included to calculate the fiscal impulse due to its limited influence on growth and the lack of a consistent estimate for the neutral rate.

A limited outlook for fiscal stimulus

Even modest shifts toward fiscal easing could have an outsized market impact. We see upside risks to fiscal stimulus – and uncertainty over U.S. fiscal policy will be high heading into the election.

Global fiscal impulse from G3 and China, 2002–2020



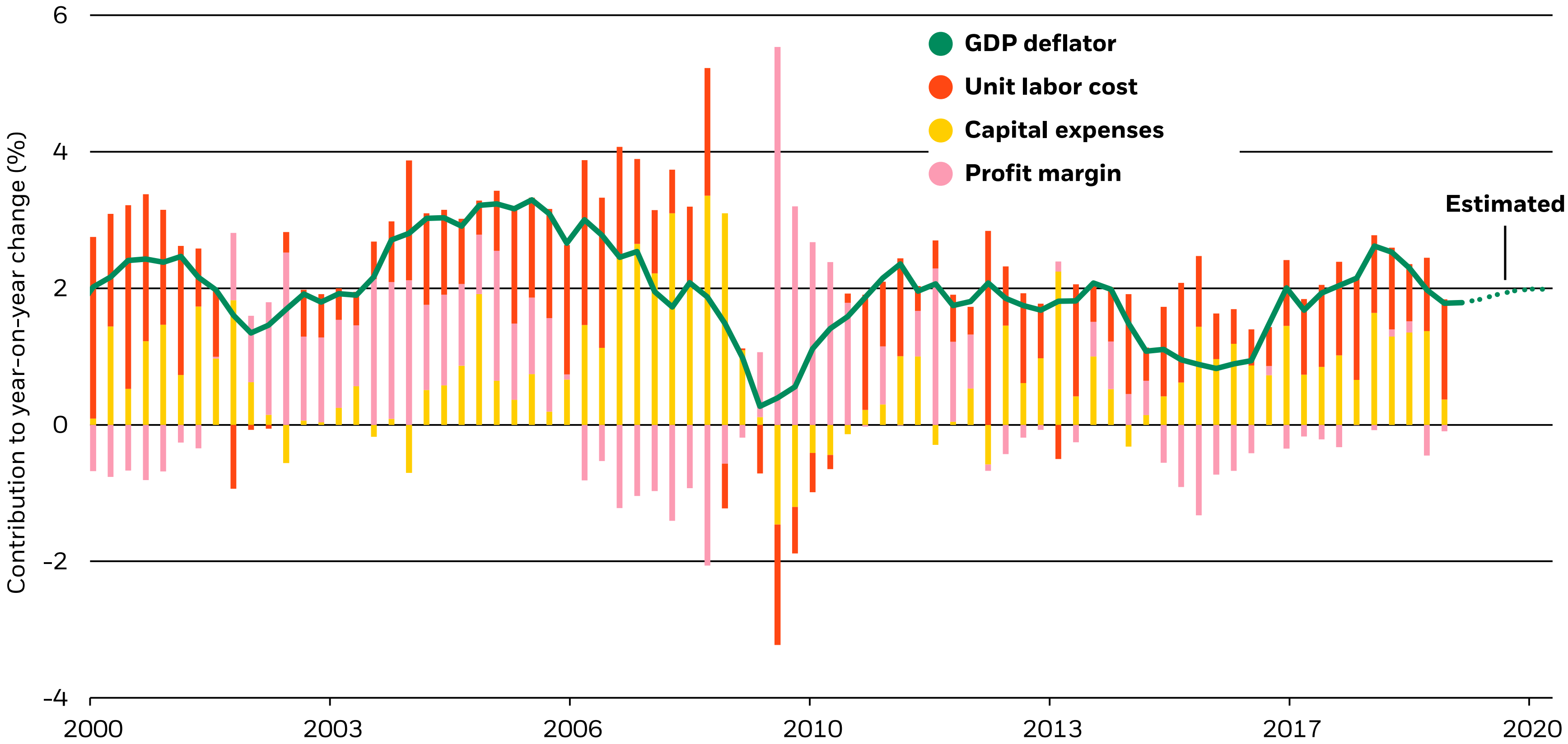
There is no guarantee that any forecasts made will come to pass.

Source: BlackRock Investment Institute, IMF, OECD and the European Commission, with data from Bloomberg, December 2019. The chart shows the annual change in the cyclically adjusted government primary balance weighted by GDP in purchasing power parity terms. The bars show the fiscal impulse from each region relative to the size of the global economy. 2020's estimated path implies mild fiscal stimulus consistent with views from the IMF, OECD and brokers. The impact of monetary easing in China is not included to calculate the fiscal impulse due to its limited influence on growth and the lack of a consistent estimate for the neutral rate.

Eyes on inflation risks

Tight labor markets, rising wages and sluggish productivity growth could stoke inflation. A disruption of global supply chains could lead to inflationary supply shocks.

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



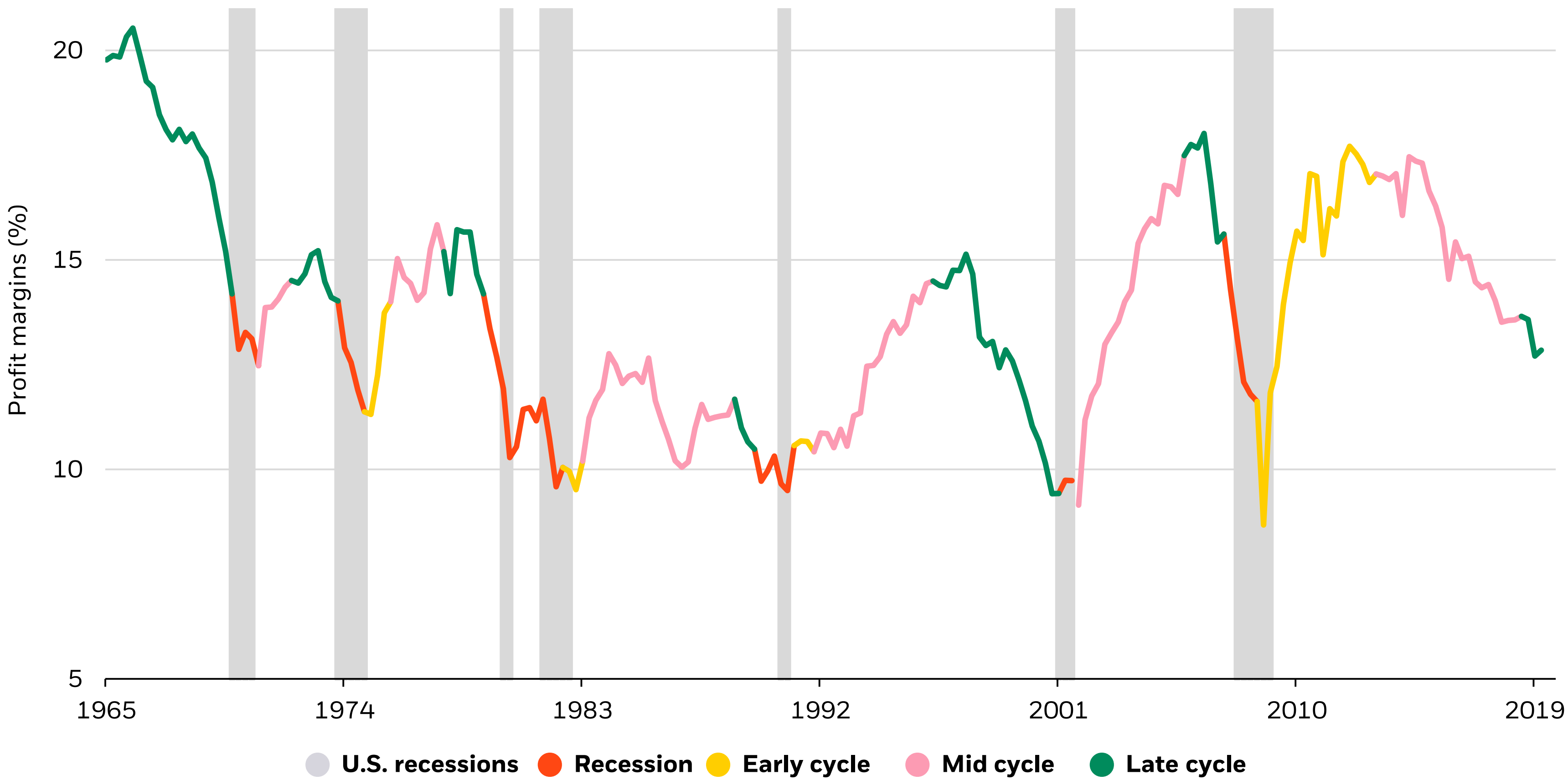
There is no guarantee that any forecasts made will come to pass.

Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis and Refinitiv, December 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.

Profit margins under pressure

A broad measure of U.S. corporate profit margins has fallen sharply from its peaks. The potential for further margin compression and downward earnings revisions is a risk for equities.

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, December 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 accounts data (NIPA) from the BEA.

Understanding macro regimes

We could shift into a Goldilocks regime if growth accelerates and inflation moderates – a positive for risk asset returns. The risk: a growth undershoot coupled with rising inflationary pressures.

Current regime

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

Our 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.

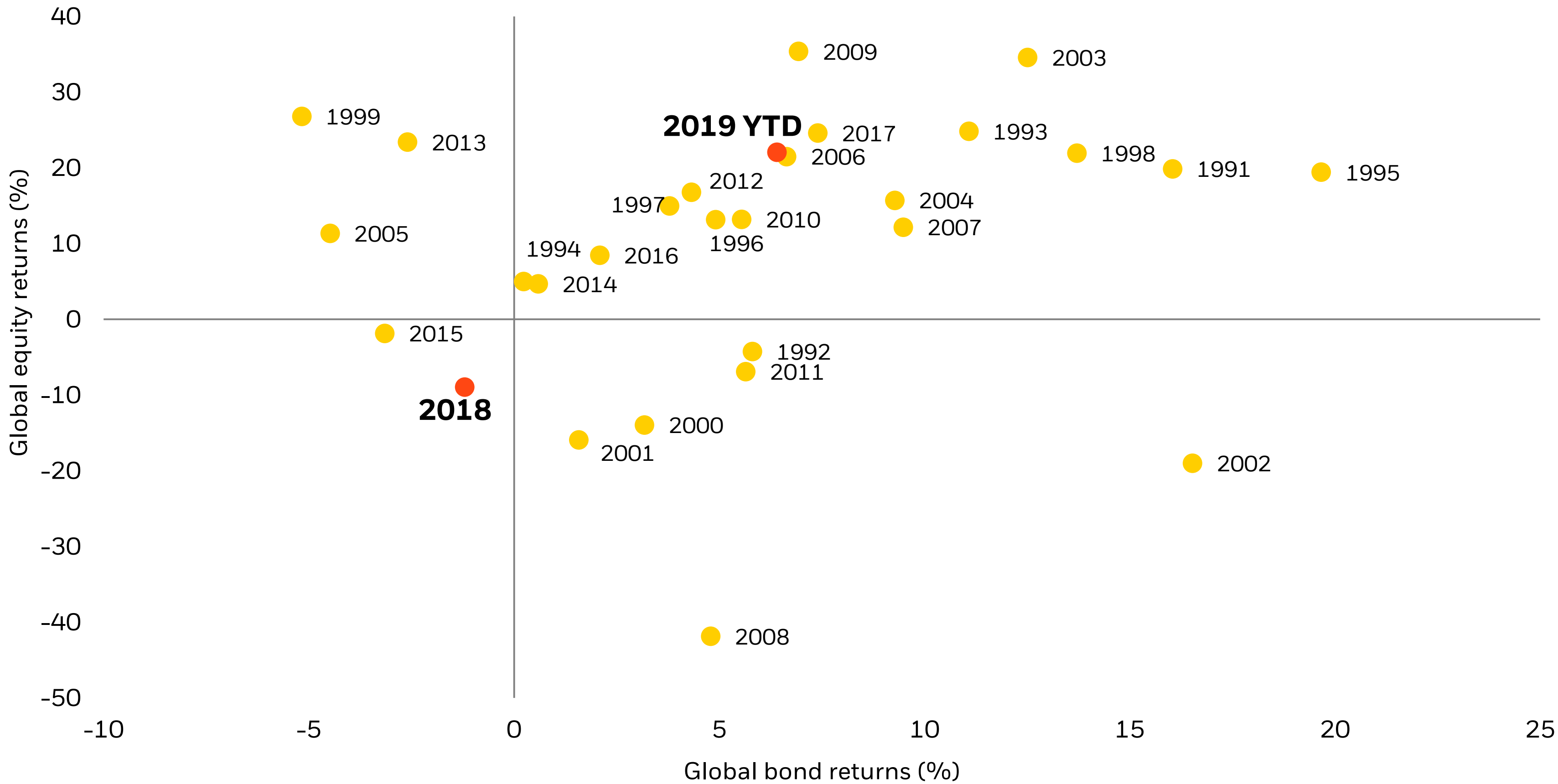
Running hot: Monetary policy tightening to limit vulnerabilities, including inflation and financial.

Sources: BlackRock Investment Institute, December 2019. Note: For illustrative purposes only.

Setting the scene

Both global stocks and bonds posted relatively healthy gains in 2019. This follows an atypical 2018 when both fell in tandem – only the second such occurrence since 1991.

Annual asset performance, 1991–2019



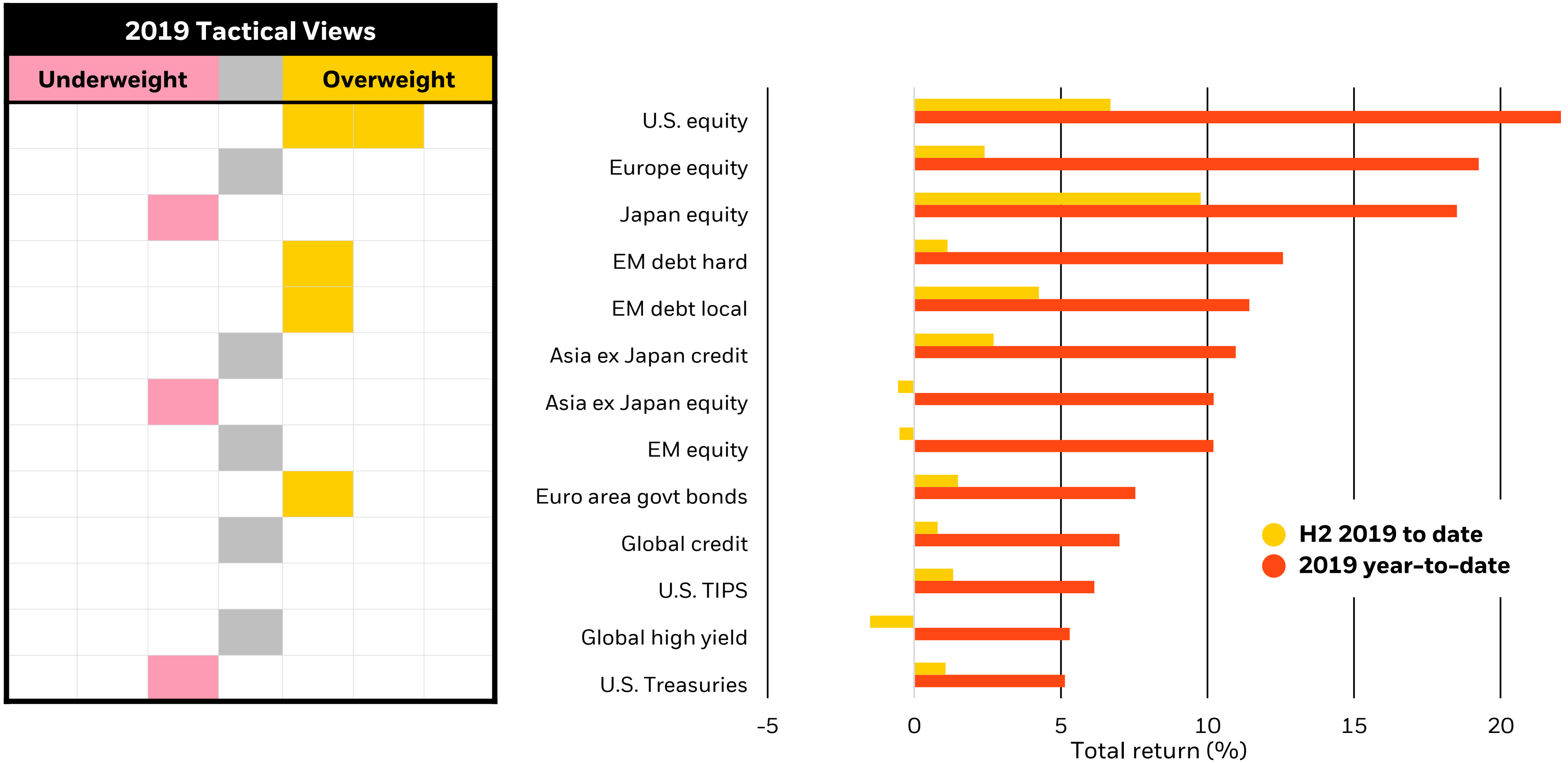
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Source: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019 Notes: Data are through 4th December 2019. Indexes or prices used are: MSCI AC World Index, and Bloomberg Barclays Global Aggregate Index. Returns are shown in USD. Indexes are unmanaged and not subject to fees.

Scoring our views

Risk assets have performed strongly in 2019 despite the blows from trade tensions and geopolitical risks. Government bonds have also performed well – and played an important diversification role.

Asset performance, 2019 second-half and year-to-date



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Source: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019 Notes: Data are through 4th December 2019. Indexes or prices used are: MSCI USA Index , MSCI Europe Index , MSCI Japan Index, JPM EMBI Global Diversified Index, JPM GBI-EM Global Diversified Composite Index, Bloomberg Barclays Non-Japan Asia Credit Index, MSCI AC ASIA ex. Japan Index, MSCI EM Index, FTSE EMU Government Bond Index all maturities Index, Bloomberg Barclays Global Credit Index, U.S. TIPS USD Index, Bloomberg Barclays Global High Yield Index and Bloomberg Barclays U.S. Treasury Index. Returns are shown in USD. Indexes are unmanaged and not subject to fees.

Directional views

Tactical views on major global asset classes from a U.S. dollar perspective, December 2019

Asset	Underweight	Neutral	Overweight

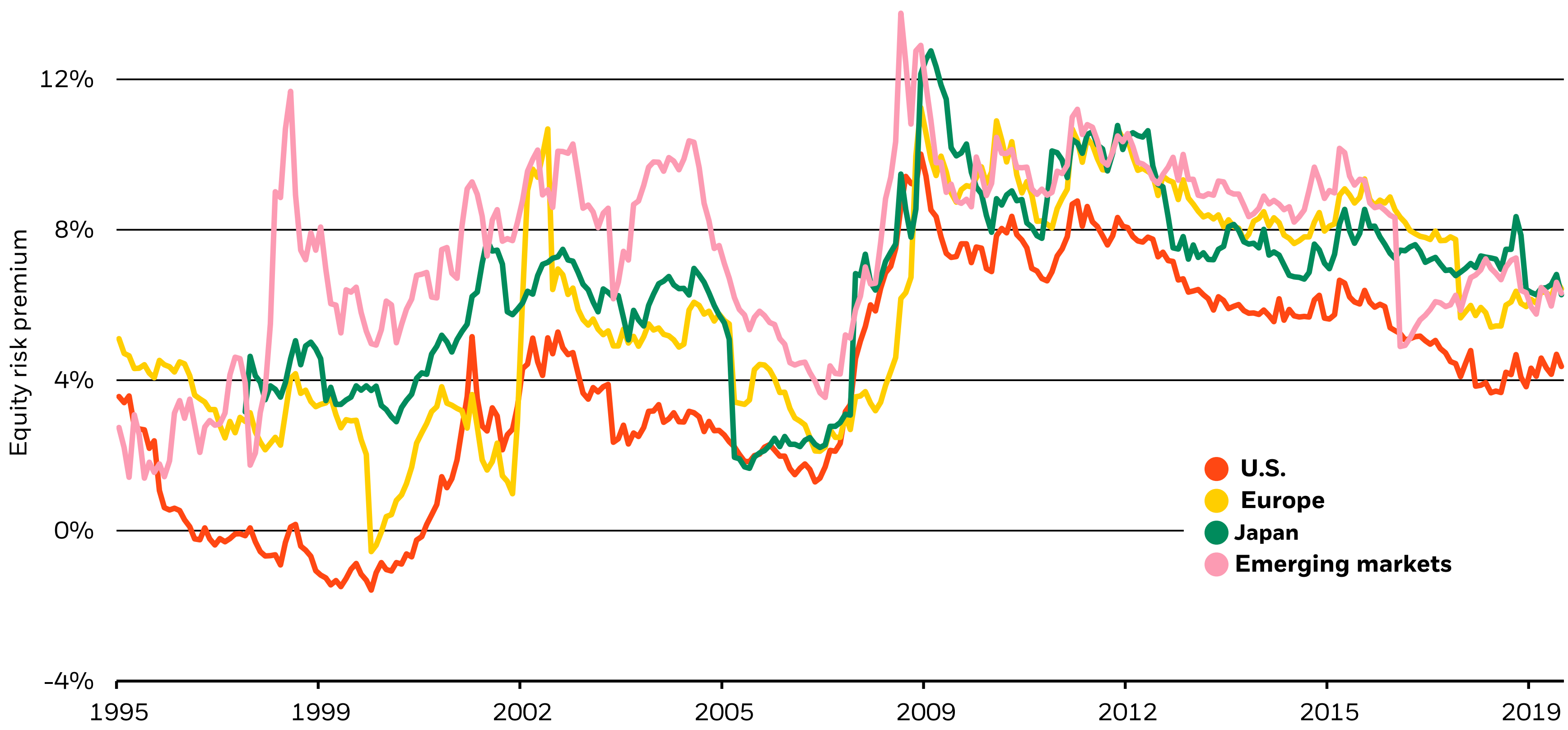
Equities	We remain modestly overweight on equities. With central bank easing and expansion in valuation multiples largely behind us, we expect a growth uptick to take over as a key support. Valuations still look reasonable. An uptick in global manufacturing and trade activity favors a tilt into more 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.
Govt 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 boost inflation.
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: Views are from a U.S. dollar perspective as of December 2019. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Equity risk premium

Compensation for equity risk looks reasonable compared with previous periods of stretched valuations.

Equity risk premia, 1995–2019



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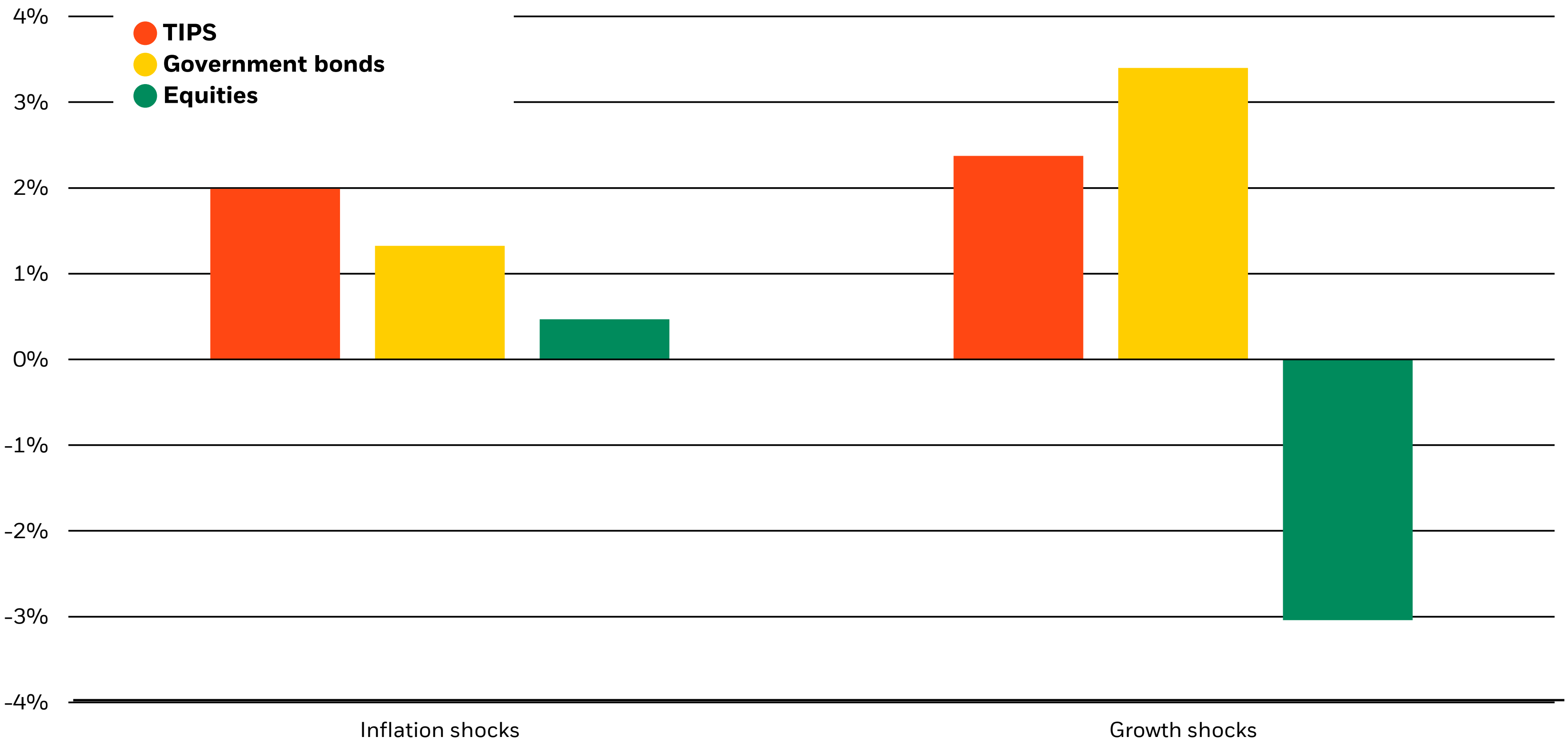
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: Data as of Sept. 31, 2019. We calculate the equity risk premium based on our expectations for nominal interest rates and the earnings yields for respective equity markets. We use MSCI indices as the proxy for the markets shown. We use our BlackRock expectations for interest rates so the estimate is not influenced by the term premium in long-term bond yields.

Reasons to like inflation-linked bonds

U.S. Treasury inflation-protected securities (TIPS) offer some diversification during both growth and inflation shocks.

Average asset returns under inflation and growth shocks, 1997-2019



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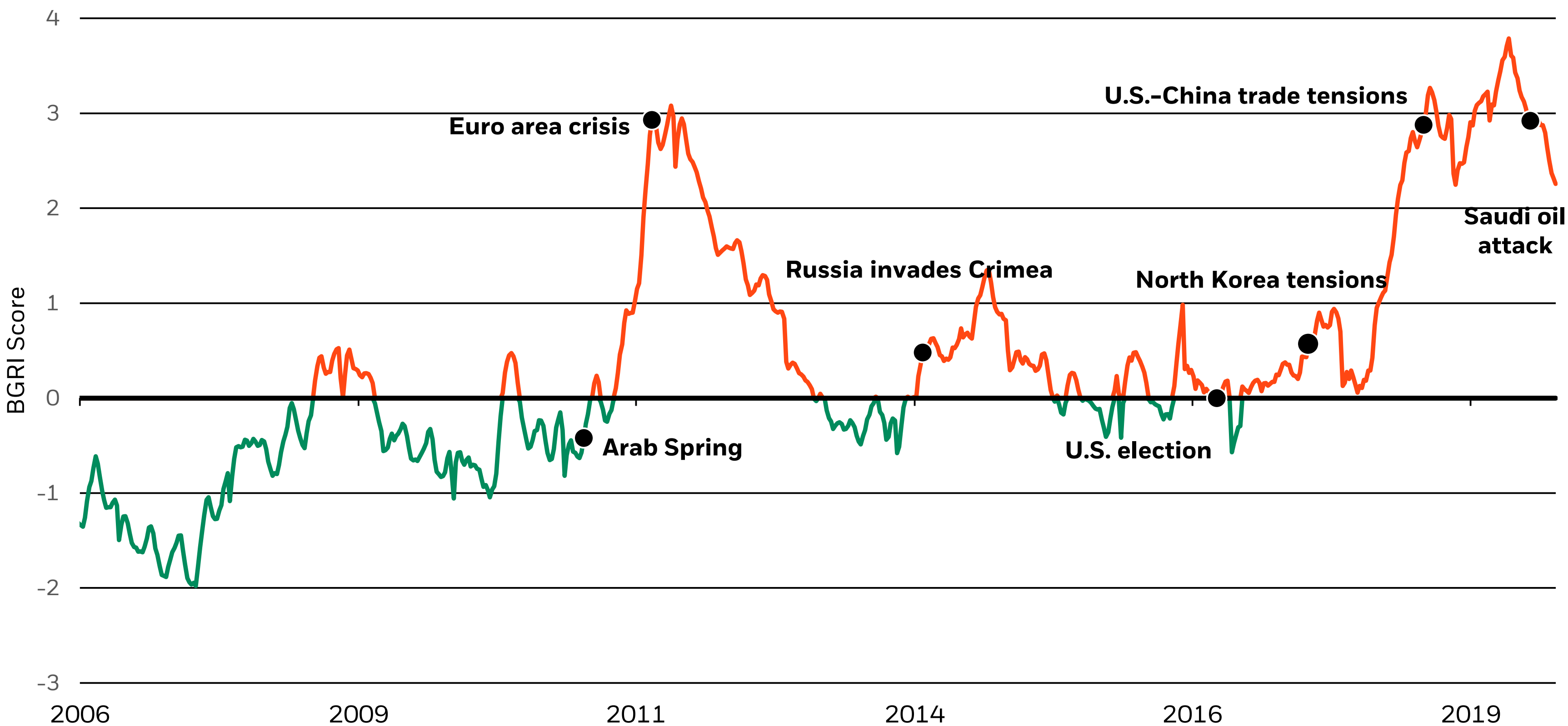
Sources: BlackRock Investment Institute, MSCI, Citigroup, with data from Refinitiv Datastream, December 2019. Notes: The chart shows quarterly returns for US government bonds (Bloomberg Barclays US Treasury Total Return), TIPS (Bloomberg Barclays US Treasury inflation notes total return index) and equities (MSCI USA Total Return index) in US dollar terms during upside inflation shocks and downside growth shocks. The periods for inflation and growth shocks are measured as those quarters during which Citi's inflation and growth surprise indexes recorded a greater than 1 standard deviation relative to their history. Indexes are unmanaged and not subject to fees.

Market attention to geopolitical risks remains high

We view the latest lull in U.S.-China trade tensions as temporary as it does not address strategic issues. A breakdown of talks could revive protectionist pressures and undermine sentiment.

BlackRock Geopolitical Risk Indicator, 2006–2019

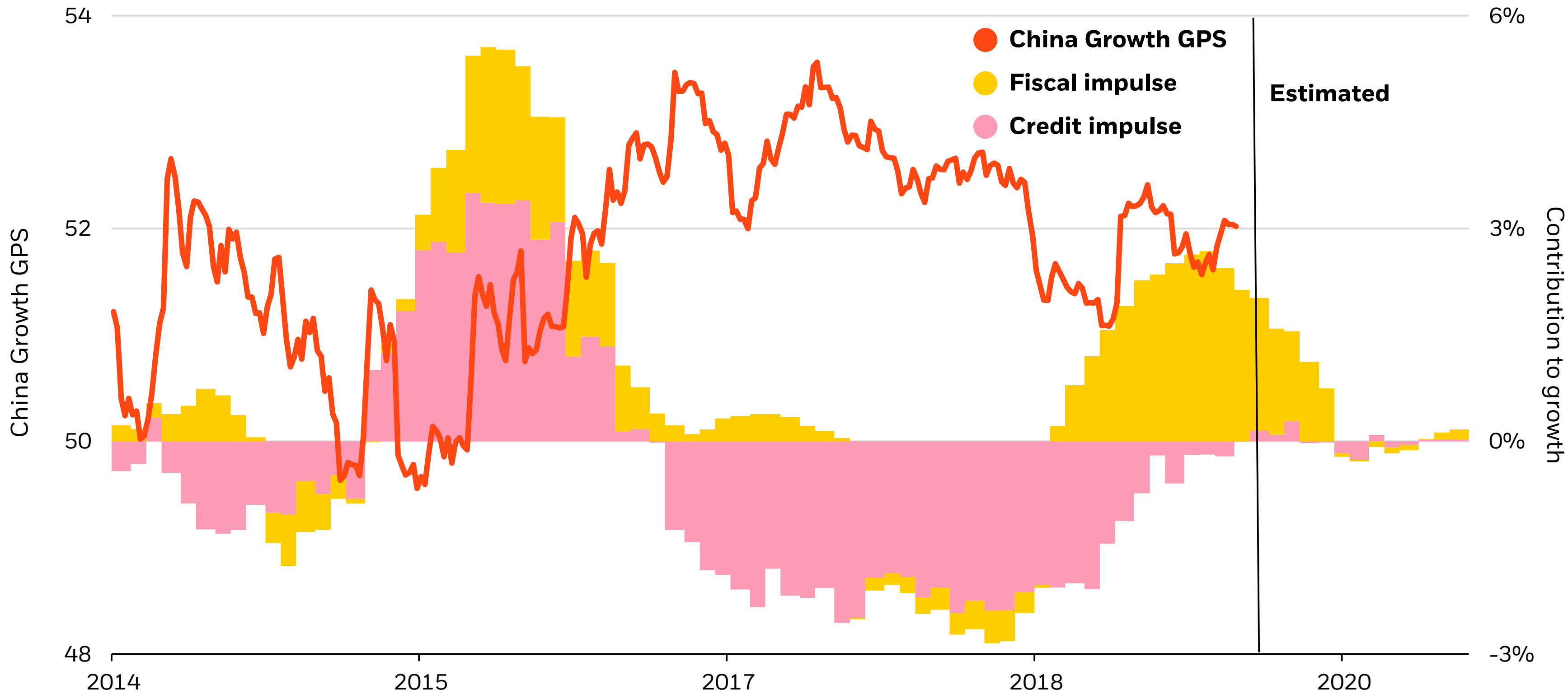


Source: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: See BlackRock's Geopolitical risk dashboard for full details. Source: BlackRock Investment Institute, with data from Refinitiv, November 2019. Notes: We identify specific words related to geopolitical risk 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.

China fiscal outlook also limited

We see little appetite in China for large-scale stimulus that has buoyed the global economy in the past. Our baseline expectation is for China's fiscal impulse to peter out next year.

China's credit and fiscal impulses, Growth GPS, 2013–2020



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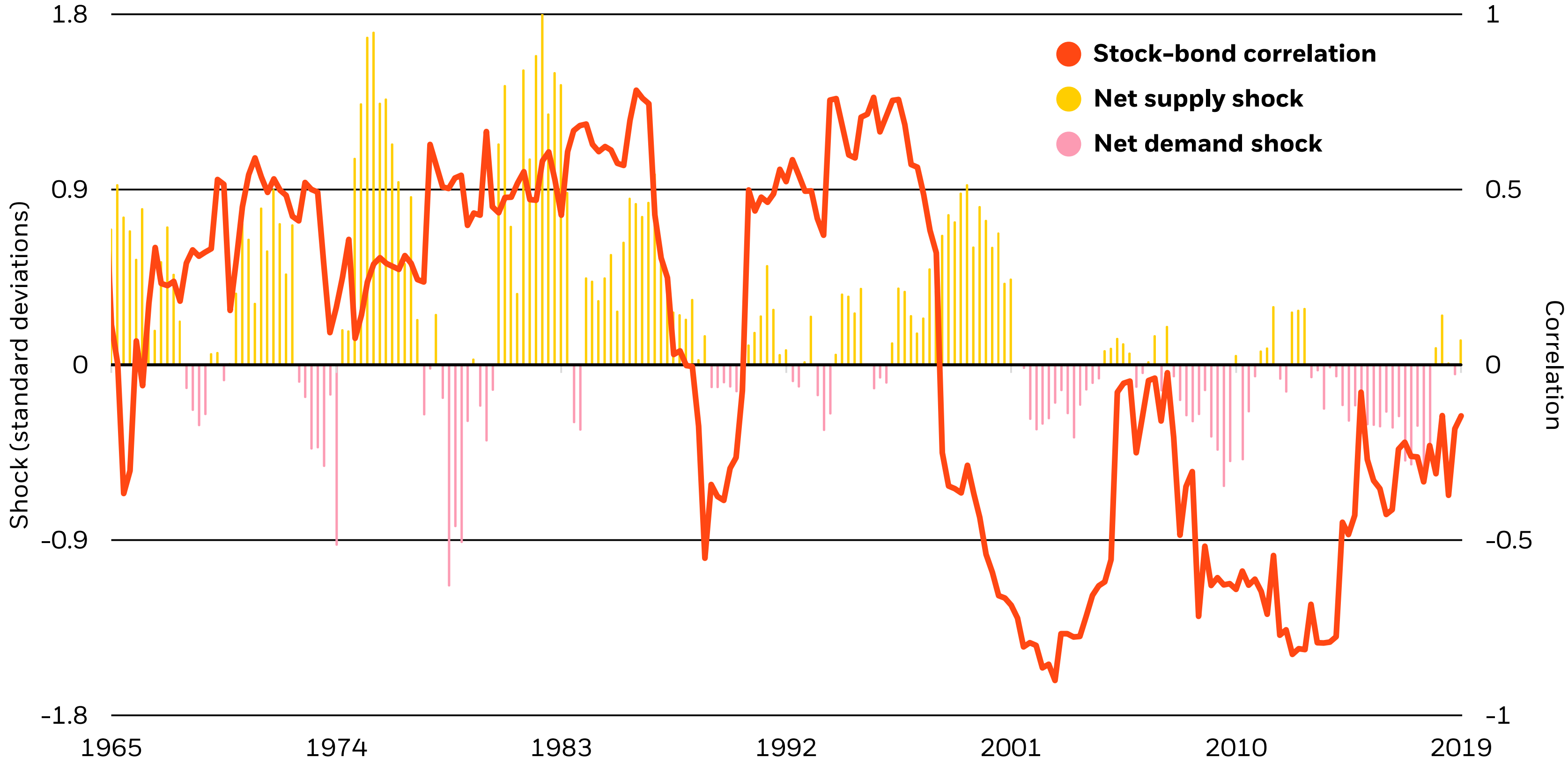
Sources: BlackRock Investment Institute, National Bureau of Statistics of China, the People's Bank of China and Consensus Economics, with data from Refinitiv Datastream, December 2019. Notes: The fiscal impulse is defined as the 12-month change in the annual fiscal deficit as a percentage of GDP. The 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.

Risk of a supply shock

The primary risk to the outlook is a stubborn mix of slower growth and rising inflation. Secular trends such as deglobalization and moves towards sustainable business models could prompt a regime shift.

Stock-bond correlations under different shocks, 1965-2019



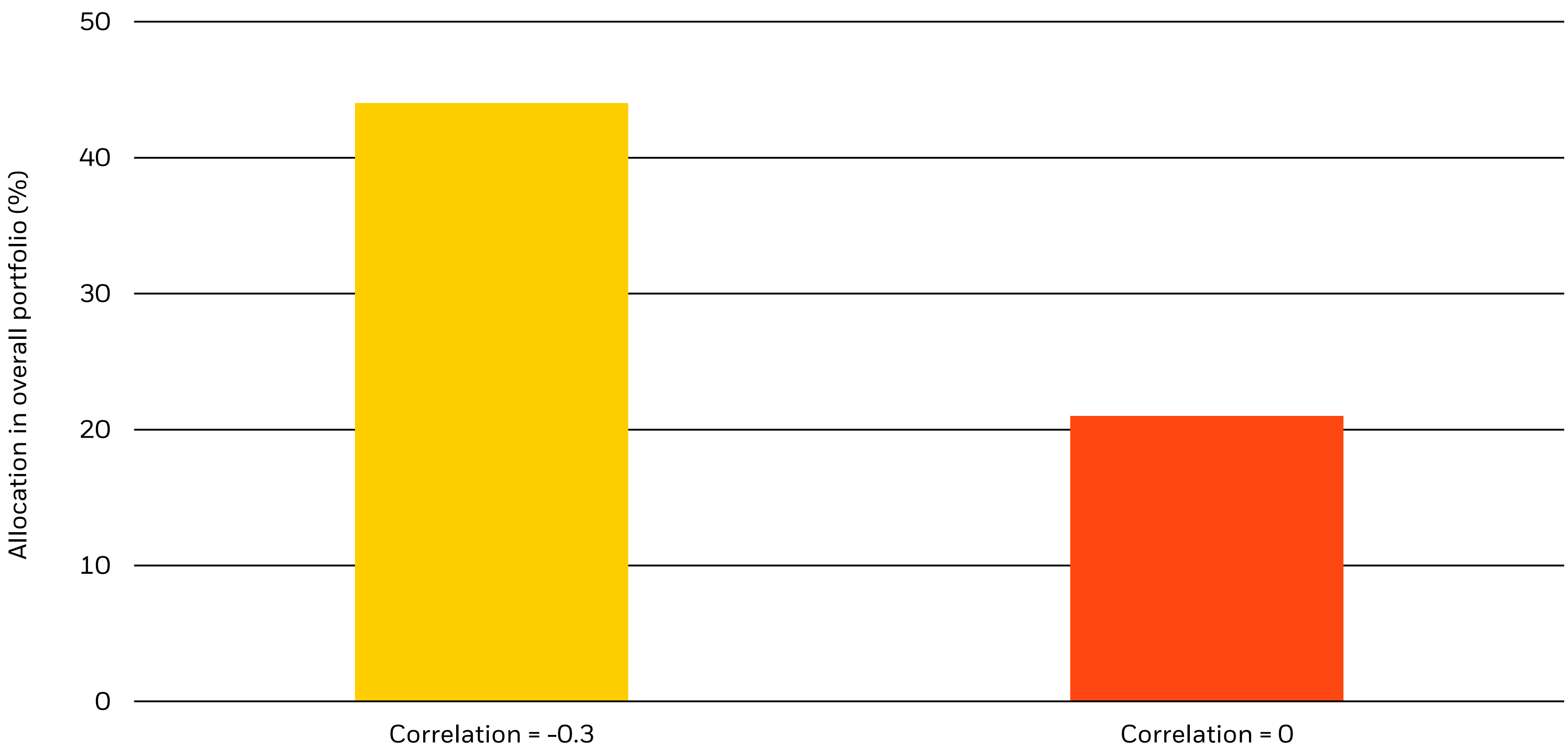
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute and the Federal Reserve, November 2019. Notes: The orange line in this chart shows the correlation between quarterly U.S. stocks and bonds 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.

Government bonds testing limits

The negative stock-bond correlation is crucial for diversification in multi-asset portfolios. If the correlation becomes less negative near the lower bound on yields, bond allocations should shrink.

Hypothetical government bond allocation under different stock-bond correlations



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, December 2019. Notes: The chart shows strategic allocations to global government bonds in a hypothetical multiasset portfolio under two scenarios: 1) an assumed 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 perform an optimization 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.

Granular tactical views

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

Change in view
Previous → New

	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 policy outcomes may weigh on sentiment and prevent a repeat of outperformance.
Equities	Europe		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.
Equities	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.
Equities	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.
Equities	Asia ex Japan		We have upgraded Asia-ex-Japan equities to neutral amid prospects of a growth uptick. A worse-than expected Chinese slowdown or disruptions in global trade pose downside risks.
Equities	Momentum		We have downgraded momentum due to its stretched pricing. The factor has underperformed most other style factors in the second half of 2019.
Equities	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.
Equities	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 relative to other factors.
Equities	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.
Fixed Income	Treasury Inflation-Protected Securities		We like TIPS due to cheap valuations relative to current inflation levels – and potential for more price rise due to wage pressures, an uptick in activity and longer-term deglobalization.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Emerging market – hard currency		We still like hard-currency EM debt against a favorable backdrop of dovish EM central banks, an improving growth outlook and a stable U.S. dollar. We prefer the high-yielders.
Fixed Income	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 major central banks stick to easy policies.
Fixed Income	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.

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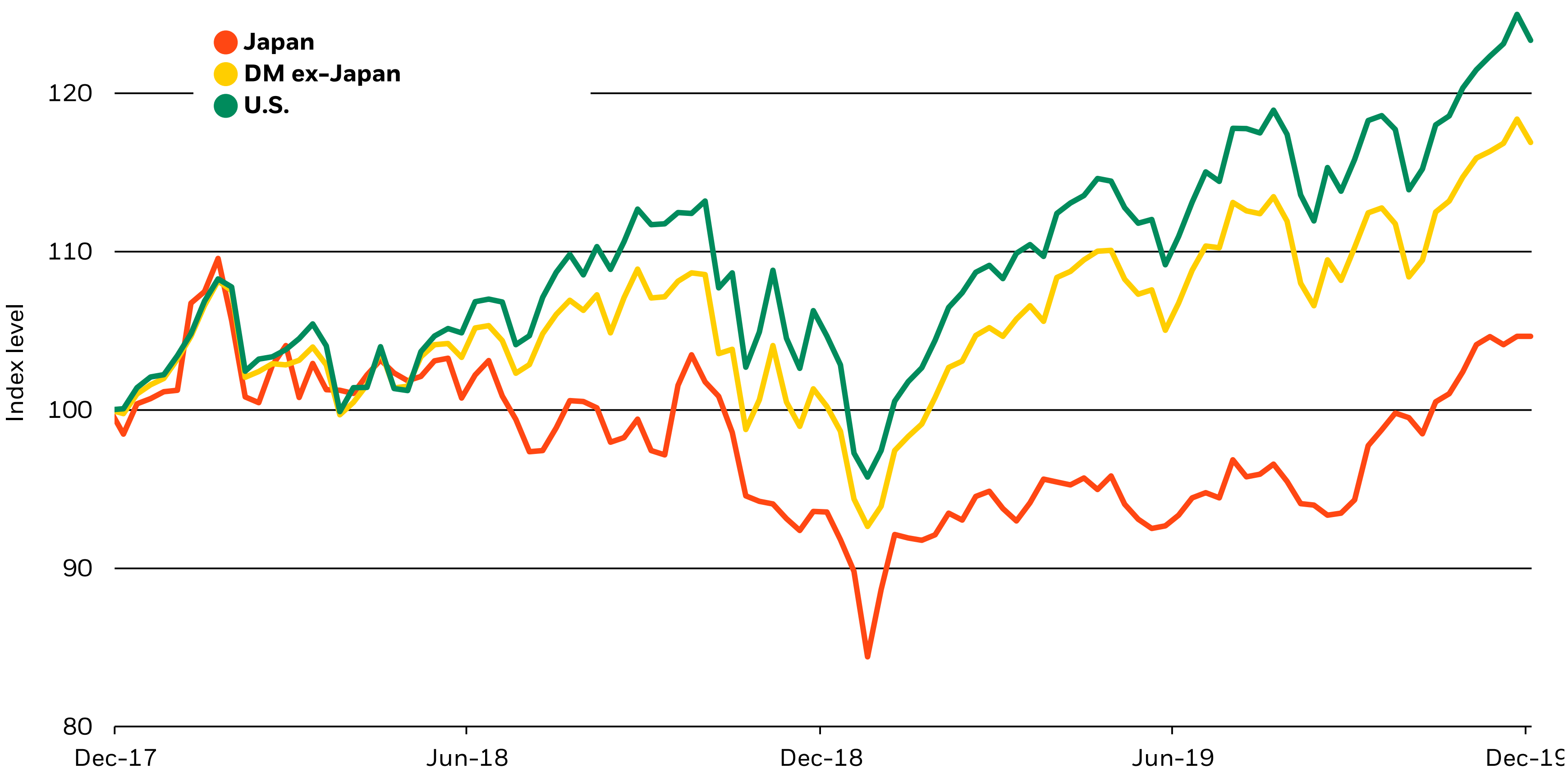
Tactically liking Japanese equities

A stabilization in global industrial production boosts the appeal of assets geared to a cyclical bounce. We see the lull in U.S.-China trade tensions as another reason to be tactically positive on Japan.

Japanese equities vs. developed market U.S. dollar total returns, 2017-2019



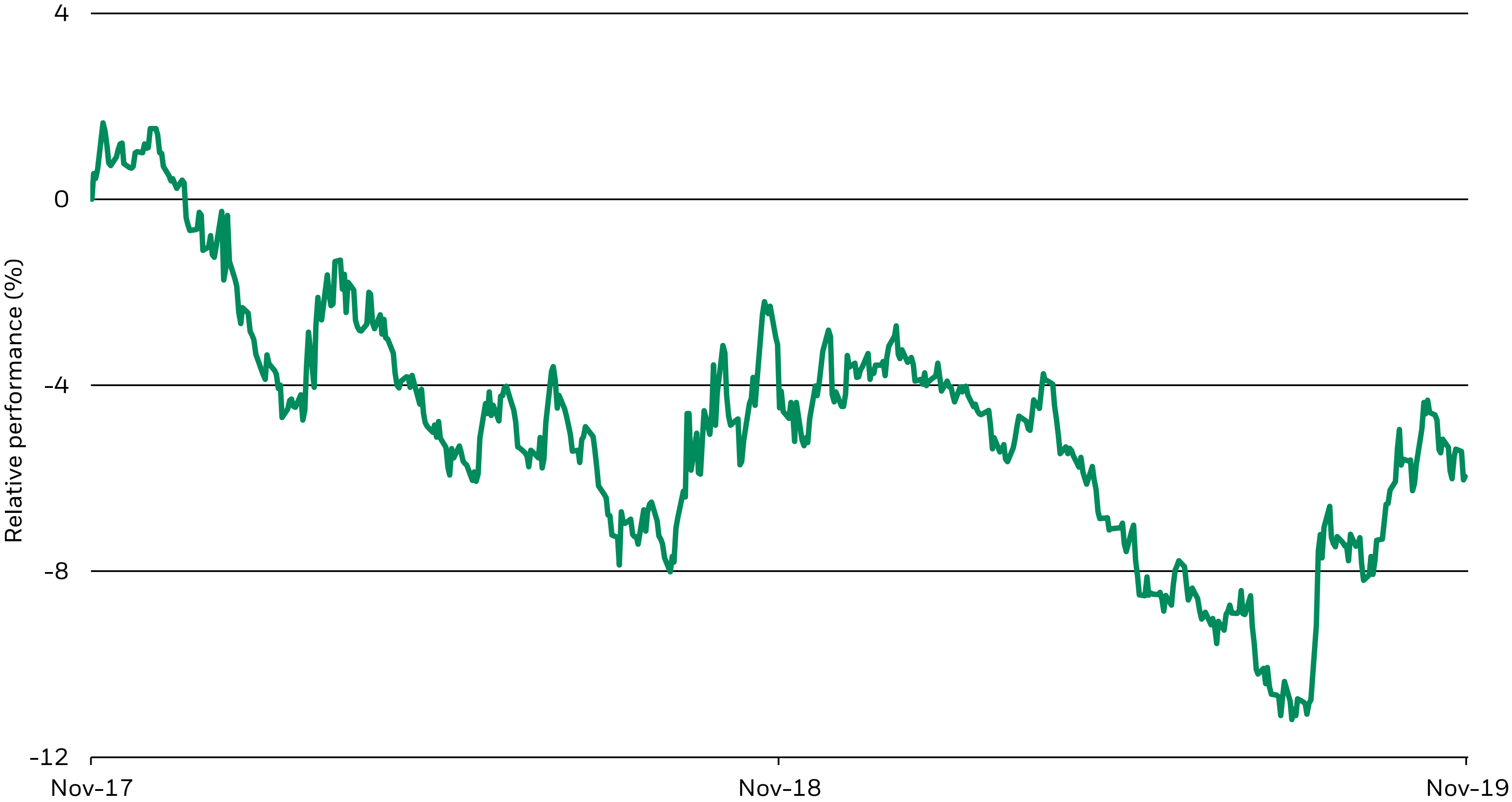
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute and MSCI, with data from Refinitiv Datastream, December 2019. Notes: The chart shows total returns for the MSCI Japan, World ex-Japan and USA rebased from Dec. 2, 2017. Returns are shown in USD. Indexes are unmanaged and not subject to fees.

Revising our factor views

We are more constructive on the value style factor now due to its pro-cyclical nature and a steepening yield curve. We like the quality factor as it is typically resilient to late-cycle risks.

Value vs. momentum factor, 2017-2019



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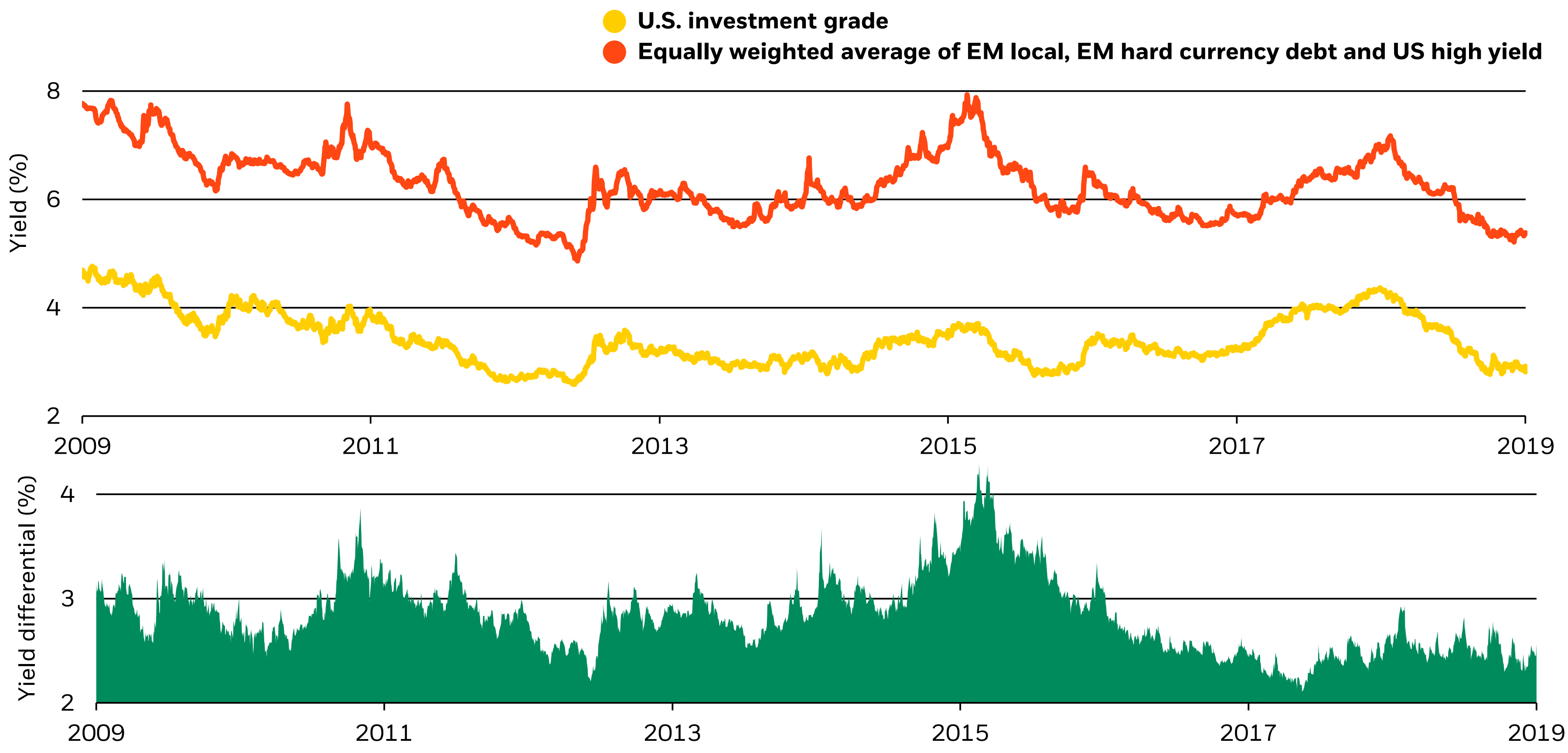
Sources: BlackRock Investment Institute, MSCI, with data from Refinitiv Datastream, December 2019. Notes: The chart shows the relative performance of MSCI World Momentum Index and MSCI World Enhanced Value Index. Returns are shown in USD.

The importance of income

We prefer EM local- and hard-currency debt and U.S. high yield over global investment grade credit.

Selected higher-yielding fixed income vs. U.S. investment grade, 2009-2019



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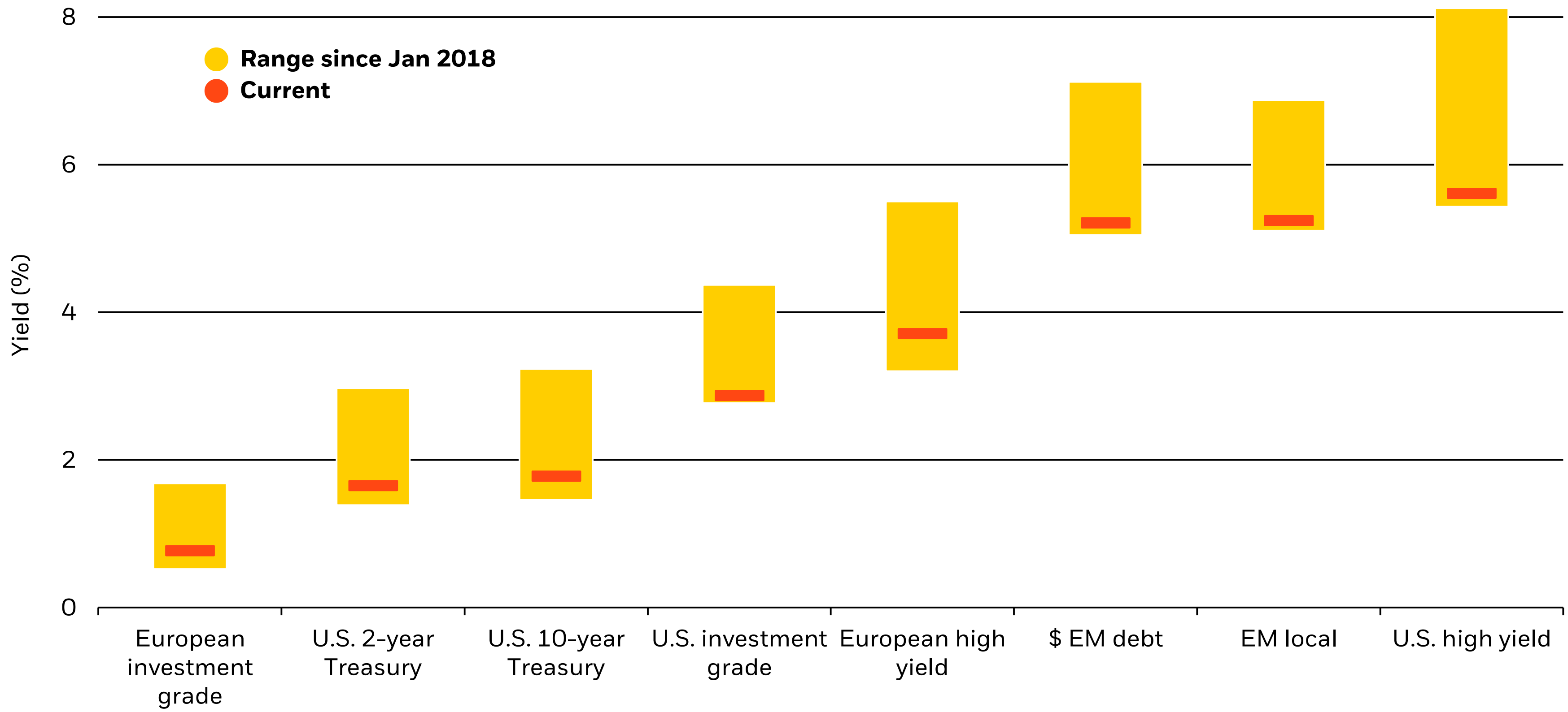
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2019. Notes: The top charts shows the yield on an equal-weighted index of JPM GBI-EM GLOBAL DIVERS Composite Index, JPM EMBI Global Diversified Index, and Bloomberg Barclays U.S. Corporate High Yield Index versus the yield on the Bloomberg Barclays U.S. Corporate Investment Grade Index. The bottom panel shows the mathematical difference between the equally weighted average of the selected higher yielding fixed income indexes shown above and the U.S. IG Index. Indexes are unmanaged and not subject to fees.

Preferring EM debt and high yield

We like sources of coupon income from higher-yielding asset classes, even as all-in yields remain near the bottom of recent ranges.

Selected fixed income yields, 2018-2019



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, Bloomberg Barclays and J.P. Morgan, December 2019. The bars show the range in yields for each index from the start of January 2018. Indices used: Bloomberg Barclays Pan-European Corporate, Refinitiv 2-year and 10-year benchmark U.S. Treasury, Bloomberg Barclays U.S. Corporate Investment Grade, Bloomberg Barclays Pan-European Corporate High Yield, J.P. Morgan GBI-Emerging Market Index, J.P. Morgan EMBI-Global Diversified Index and Bloomberg Barclays U.S. Corporate High Yield Index. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index.

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