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BLACKROCK INVESTMENT INSTITUTE

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WEEKLY COMMENTARY • MARCH 11, 2019

Key points

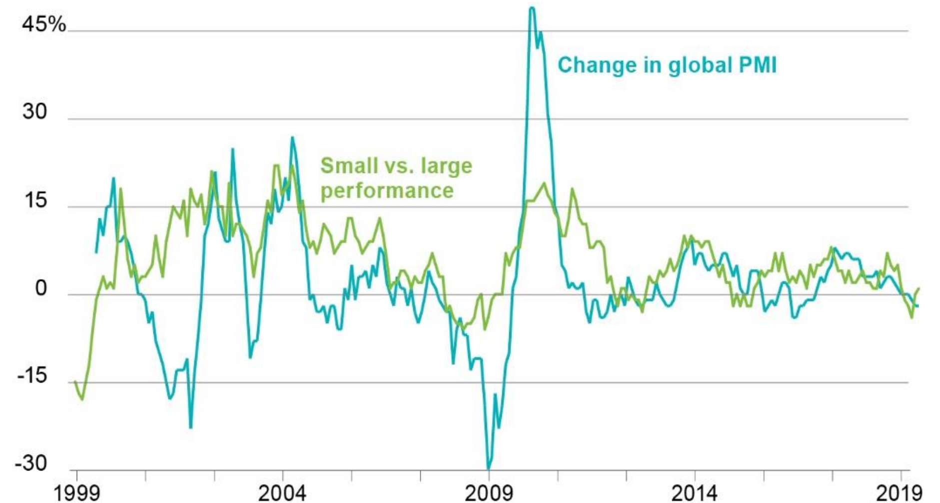
1. Small cap stocks are on a tear, yet we advise caution on chasing the rally – and favor higher-quality large cap shares.
2. A key theme last week: global stimulus aimed at boosting growth. China announced tax cuts, while major central banks turned more dovish.
3. The UK parliament will vote on a Brexit deal this Tuesday. We expect a delay to the Brexit process regardless of the vote outcome.

1 Putting the small cap rally in perspective

Global small cap stocks have had a strong 2019 so far, outperforming large caps by more than three percentage points. This is not a rally worth chasing, in our view. As the pace of the global expansion slows, we prefer large cap equities. We favor exposures to firms with quality markers such as strong balance sheets.

Chart of the week

Global PMI and small cap vs. large cap equity performance, 1999-2019



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 MSCI, Thomson Reuters and Markit/J.P. Morgan, March 2019. Notes: The small vs. large performance line shows the relative performance of the MSCI ACWI small and large cap indexes over a rolling one-year period. The change in global PMI line shows the change in IHS Markit's global composite Purchasing Managers' Index (PMI), also over a rolling one-year period.

Small caps tend to be more domestically oriented than large caps. Their sector composition is slightly more cyclical, with greater representation in sectors such as construction, real estate and manufacturing. This means they are more sensitive to changes in economic activity. The chart above shows how global small caps' relative performance has historically shown a tight relationship with swings in global Purchasing Managers' Index (PMI) data. Global composite PMIs have mostly fallen over the past year, with small cap performance following suit – until this year. Small caps have roared back to life, with only a modest recent bounce-back in PMI data. We attribute much of the small cap move to multiple expansion amid the fading of key risks to the macro outlook – higher rates and escalating trade conflicts. More dovish monetary policy guidance from central banks globally and a lessening of perceived geopolitical risk have provided relief for risk assets – and for small caps too.

Reasons for caution

We see fewer catalysts for sustained small cap outperformance ahead. Small caps tend to have higher operational leverage and less diversified businesses than larger companies in the same sectors. This leaves them less resilient during periods of decelerating growth and rising uncertainty, like the one we see ahead in 2019 as the U.S. economy enters a late-cycle phase. Meanwhile, small caps' greater average reliance on floating rate debt could pose a challenge to U.S. firms in particular, if market expectations for Federal Reserve rate increases were to reset higher. We believe markets may be underappreciating the possibility that the Fed could raise rates further this year. Lastly, small caps generally have less direct international sales than large caps, but they are often part of global supply chains that could feel pressure from slower global trade. Our indicators show markets may be complacent about trade risks.

Valuations are not flashing warning signs. Global small caps' 12-month forward price-to-earnings multiples are still modestly below their five-year averages. Small caps are trading just below their average five-year premium to large caps, and their performance is still lagging that of large caps over the past 12 months. We expect earnings across all market size segments will be challenged in the first half of 2019 on tougher year-on-year comparisons and weaker economic activity. Estimates for small cap earnings growth are nearly double those of large caps for both 2019 and 2020, but downward revisions to small cap earnings forecasts over the past three months have exceeded those for large caps. Small caps on average have thinner margins and riskier debt profiles than larger companies, leaving them more vulnerable to downgrades. More than half the debt issued by companies in the MSCI ACWI Small Cap Index is sub-investment grade. Testifying to investor caution: flows data show a trickle out of small caps since late December, even amid the rally.

Bottom line: Today's late-cycle economic environment of slowing growth and rising uncertainty calls for carefully balancing risk and reward. We advocate building portfolio resilience through high quality exposures and caution toward lower-quality market segments, such as small caps. We favor large caps for their stronger balance sheets, more diverse businesses and greater operational flexibility.

2 Week in review

- China lowered its 2019 target growth rate at its annual National People's Congress and announced fiscal stimulus measures, including cuts in its value-added tax rates for businesses. China trade data came in weaker than expected, and the U.S. goods trade deficit rose to a record high in 2018. The growing U.S. trade gap looks likely to influence ongoing U.S.-China trade negotiations.
- The European Central Bank lowered its 2019 growth forecast, announced it would keep interest rates on hold until at least the end of this year, and said it will provide a new wave of cheap funding for European banks to spur lending. The announcement sent European bond yields lower, while the euro weakened against the U.S. dollar. The Bank of Canada also held interest rates steady.
- Global stocks fell. Quality stocks outperformed momentum. Government bond yields declined globally. Global PMI data showed some improvement. February U.S. jobs growth disappointed.

Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
U.S. Large Caps	-2.1%	9.9%	2.2%	2.1%
U.S. Small Caps	-4.2%	13.1%	-1.9%	1.6%
Non-U.S. World	-1.9%	7.8%	-7.2%	3.3%
Non-U.S. Developed	-1.9%	7.5%	-6.6%	3.5%
Japan	-1.9%	4.0%	-9.1%	2.5%
Emerging	-2.0%	6.9%	-11.3%	2.8%
Asia ex-Japan	-2.1%	7.8%	-9.4%	2.6%

Bonds	Week	YTD	12 Months	Yield
U.S. Treasuries	0.8%	0.7%	3.7%	2.6%
U.S. TIPS	0.6%	1.7%	2.1%	2.8%
U.S. Investment Grade	0.7%	3.1%	3.3%	3.9%
U.S. High Yield	-0.5%	5.8%	4.1%	6.7%
U.S. Municipals	0.4%	1.6%	4.4%	2.5%
Non-U.S. Developed	-0.1%	0.4%	-4.6%	0.8%
EM $ Bonds	-0.3%	4.9%	2.6%	6.2%

Commodities	Week	YTD	12 Months	Level
Brent Crude Oil	1.0%	22.2%	3.4%	$ 65.74
Gold	0.4%	1.2%	-1.8%	$ 1,298
Copper	-1.3%	7.2%	-6.4%	$ 6,395

Currencies	Week	YTD	12 Months	Level
Euro/USD	-1.2%	-2.0%	-8.7%	1.12
USD/Yen	-0.7%	1.5%	4.7%	111.17
Pound/USD	-1.4%	2.0%	-5.8%	1.30

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Thomson Reuters. As of March 8, 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.

3 Week ahead

March 11 U.S. retail sales; IEA Market Report Oil 2019 edition

March 12 UK Parliament Brexit vote, UK GDP; U.S. Consumer Price Index (CPI)

March 14 China retail sales, industrial production, fixed-asset investment; OPEC Monthly Oil Market Report

March 15 U.S. industrial production, consumer sentiment; IEA Oil Market Report; Bank of Japan statement on monetary policy

The UK parliament will again vote on a Brexit deal this Tuesday. We expect a delay to the Brexit process of the UK's withdrawal from the European Union (EU) regardless of the vote outcome. If a deal is not passed, UK Prime Minister Theresa May has promised further votes on whether to proceed with a no-deal exit, and whether to request an extension to the Article 50 procedure for EU withdrawal. If the vote passes, the UK and the EU would likely still need more time to ratify the deal. We see a no-deal exit as unlikely given the parliamentary majority against such an outcome, although this outcome cannot be ruled out. Read 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	—	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 front end has the most appealing risk-adjusted income, but we favor going out on the curve on any material backup in yields. We see the risk/reward balance tilted toward inflation-protected securities.
	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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