

# BLACKROCK INVESTMENT INSTITUTE



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## WEEKLY COMMENTARY • APRIL 8, 2019

### Key points

- 1 We are cautious on U.S. Treasuries in the short term after the recent rally. Yet we still advocate exposure to build portfolio resilience.
- 2 March jobs growth and a slew of revised data improved the outlook for U.S. first-quarter economic activity, helping boost stocks last week.
- 3 A European Central Bank meeting will be scrutinized for any comments on weak eurozone economic data and the side effects of negative rates.

## 1 Our take on the Treasury rally

U.S. Treasury yields dropped sharply in March, breaking out of the tight range they had traded in early this year. Could yields head lower still, extending the rally in Treasury prices? We take a cautious short-term stance, and see recent moves as excessive. Yet we still like U.S. Treasuries for their key role as portfolio diversifiers.

### Chart of the week

Market pricing of 2020 U.S. interest rate moves, 2018-2019



**There is no guarantee that any forecasts made will come to pass.** Sources: BlackRock Investment Institute, with data from Bloomberg, April 2019. Notes: The chart shows the market-implied change in short-term U.S. interest rates up to Dec. 2020, as reflected by the pricing of eurodollar futures contracts. We use the Dec. 2020 contract to represent implied end-2020 rates. The implied changes are represented by the price differences between that contract and the contracts for Dec. 2018, Jan. 2019, Feb. 2019, March 2019 and April 2019 delivery, moving one contract forward each time a contract expires. We assume rate moves are 0.25 percentage points.

Just one illustration of the extent of the recent rally: The 5-year U.S. Treasury yield fell to 2.25% from 2.5% over the course of March, a similar move not seen since the late-December drop in global equity markets. Yields have recovered somewhat in early April, but remain well below early-March peaks. A major factor fueling the rally in Treasury prices: Market reaction to the Federal Reserve's dovish pivot this year, with the central bank indicating its rate hike pause could be an extended one. Yet we believe market expectations of Fed policy have become too dovish. Markets have swung from pricing in two quarter-percentage-point Fed rate increases between fall 2018 through the end of 2020 to now pricing in two decreases by the end of 2020. See the line's drastic downward shift since last fall in the chart above. We still expect the Fed's next rate move to be up — just not for a while as the Fed remains on hold.

## Be patient like the Fed

We also attribute the U.S. government bond rally to markets overreacting to surprisingly weak European economic data. The data reinforced the economic downside risks the European Central Bank (ECB) pointed to in early March, when it gave a more dovish forward guidance for rates. This was part of a global dovish shift in central bank policy. Investors appear to have interpreted the weak European data as a sign that the global economy is slowing more than previously expected. We do see global growth slowing as the long post-crisis expansion nears its final stage, but we expect the global economy can remain in the late-cycle phase, avoiding recession throughout 2019 (see our [Global investment outlook Q2 2019](#)). A rebounding Chinese economy should help global growth, and U.S. growth is again poised to outpace that of developed peers, including Europe.

The recent surprise move lower in Treasury yields also seems to have been exacerbated by technical factors. When bond yields broke sharply below their recent ranges, some investors in markets such as U.S. mortgages were prompted to buy additional U.S. Treasuries to hedge their positions. This type of buying rarely has a long-lasting impact on a market as liquid as that of U.S. Treasuries, in our view. Against this backdrop, we advocate patience before adding to U.S. Treasuries exposure, and see yields moving back into their early-2019 range (2.4% to 2.6% for the 5-year yield). We focus on the 5-year, as a relatively flat yield curve means the incremental yield currently offered by longer-term exposures is not worth the extra interest rate risk, in our view.

We do see Treasuries retaining their attraction as portfolio diversifiers. The traditional inverse relationship between U.S. equity and government bond returns is alive and well. We see the negative correlation being sustained in this late-cycle period, with Treasuries acting as a buffer to any selloffs in risk assets driven by growth scares. In fixed income overall, we still see income as king. We expect income (carry) to power returns in the quarters ahead, taking the reins from price appreciation. We prefer shorter-dated bonds and allocations to inflation-protected securities, amid the likelihood of a steeper yield curve and higher market-based inflation expectations.

## 2 Week in review

- Global stocks climbed, led by gains in Asia and Europe. Materials was the top-performing global sector and financials rebounded, while defensive sectors underperformed their peers. Quality was the strongest performing style factor.
- Markets digested better-than-expected China Purchasing Managers' Index data showing manufacturing activity expanded in March at its fastest pace in eight months. A greater-than-forecast March rebound in U.S. hiring, and upward revisions to U.S. business inventories, construction and retail sales data, implied U.S. first-quarter economic activity was more solid than previously expected. Industrial orders in Germany surprised to the downside, extending the trend in recent months of weak eurozone economic data.
- The British government requested a further Brexit delay. The presidents of the U.S. and China said their countries made progress on a trade deal, but they did not yet schedule a meeting (see our [geopolitical risk dashboard](#) for more on U.S.-China tensions).

### Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	2.1%	16.0%	10.8%	2.0%
<b>U.S. Small Caps</b>	2.8%	17.8%	4.0%	1.6%
<b>Non-U.S. World</b>	2.2%	12.8%	-1.9%	3.1%
<b>Non-U.S. Developed</b>	2.0%	12.3%	-1.7%	3.3%
<b>Japan</b>	1.2%	8.2%	-5.7%	2.4%
<b>Emerging</b>	2.6%	12.8%	-4.3%	2.6%
<b>Asia ex-Japan</b>	2.4%	14.1%	-1.8%	2.5%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	2.9%	30.7%	2.9%	\$ 70.34
<b>Gold</b>	0.0%	0.7%	-2.6%	\$ 1,292
<b>Copper</b>	-1.3%	7.3%	-6.1%	\$ 6,401

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	-0.5%	1.6%	4.2%	2.5%
<b>U.S. TIPS</b>	-0.4%	2.8%	2.7%	2.7%
<b>U.S. Investment Grade</b>	-0.2%	4.9%	5.1%	3.7%
<b>U.S. High Yield</b>	0.5%	7.8%	6.2%	6.3%
<b>U.S. Municipals</b>	-0.3%	2.6%	5.2%	2.4%
<b>Non-U.S. Developed</b>	-0.7%	0.9%	-4.1%	0.8%
<b>EM \$ Bonds</b>	0.3%	7.2%	4.2%	6.0%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	0.0%	-2.2%	-8.4%	1.12
<b>USD/Yen</b>	0.8%	2.0%	4.1%	111.74
<b>Pound/USD</b>	0.0%	2.2%	-6.9%	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 April 5, 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

**April 10**

U.S. Consumer Price Index (CPI), FOMC minutes; ECB meeting and press conference, European Union emergency summit; UK GDP

**April 12**

Eurozone industrial production; U.S. consumer sentiment index, U.S. banks kick off first-quarter earnings season

**April 11**

China CPI

This week's ECB's meeting and press conference will be closely watched for any reaction from the central bank to the recent deterioration in eurozone economic data. Also warranting attention: any discussion on the effectiveness of the central bank's negative rate policy and its impact on bank profitability. Remarks from ECB President Mario Draghi in late March signaled the central bank may consider measures to mitigate the impact on the financial sector, while seeking to preserve the overall economic benefits of negative rates. Ongoing policy accommodation is warranted in our view, and we expect the ECB to keep rates on hold until at least year end.

## Asset class views

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

Asset class	View	Comments
Equities	U.S.	▲ A slowing but still growing economy underlies our positive view. We prefer quality companies with strong balance sheets in a late-cycle environment. Health care and technology are 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 firms.
	Japan	— Cheap valuations are supportive, along with shareholder-friendly corporate behavior, central bank stock buying and political stability. Earnings uncertainty is a key risk.
	EM	▲ Economic reforms and policy stimulus support EM stocks. Improved consumption and economic activity from Chinese stimulus could help offset any trade-related weakness. 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	— We are cautious on U.S. Treasury valuations after the recent rally, but still see them as portfolio diversifiers given their negative correlation with equities. We expect a gradual steepening of the yield curve, driven by still-solid U.S. growth, a Fed willing to tolerate inflation overshoots — and a potential shift in the Fed's balance sheet toward shorter-term maturities. This supports two- to five-year maturities and inflation-protected securities.
	U.S. municipals	▲ We see coupon-like returns amid a benign interest rate backdrop and favorable supply-demand dynamics. New issuance is lagging the total amount of debt that is called, refunded or matures. The tax overhaul has made munis' tax-exempt status more attractive in many U.S. states, driving inflows.
	U.S. credit	— A still-growing economy, reduced macro volatility and a decline in issuance support credit markets. Conservative corporate behavior — including lower mergers and acquisitions volume and a focus on balance sheet strength — also help. We favor BBBs and prefer bonds over loans in high yield.
	European sovereigns	▼ Low yields, European political risks, and the potential for a market reassessment of easy ECB policy or pessimistic euro area growth expectations all make us wary on European sovereigns, particularly peripherals. Yet any further deterioration in U.S.-European trade tensions could push yields lower.
	European credit	▼ "Low for longer" ECB policy should reduce market volatility and support credit as a source of income. European bank balance sheets have improved after years of repair, underpinning fundamentals. Yet valuations are rich after a dramatic rally. We prefer high yield credits, supported by muted issuance and strong inflows.
	EM debt	— Prospects for a Chinese growth turnaround and a pause in U.S. dollar strength support both local- and hard-currency markets. Valuations are attractive despite the recent rally, with limited issuance adding to positives. Risks include worsening U.S.-China relations and slower global growth.
	Asia fixed income	— 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. We are cautious on Chinese government debt despite its inclusion in global indexes from April. We see rising funding needs outstripping foreign inflows.
Other	Commodities and currencies	* A reversal of recent oversupply is likely to underpin oil prices. Any relaxation in trade tensions could boost industrial metal prices. We are neutral on the U.S. dollar. It has perceived "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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