Weekly commentary

BlackRock.

Sept. 23, 2019

Our take on the factor reversal

- A rebound in bond yields has led to a shakeup in equity market factor returns. We prefer defensive factors such as min vol as growth slows.
- The Fed cut interest rates, but its noncommittal view on the rate outlook suggests expectations for rate cuts are likely overdone.
- This week's economic data are key for gauging the extent of the global manufacturing slowdown and the health of the U.S. consumer.

A perceived lull in U.S.-China trade tensions has eased market fears about an economic downturn, prompting a rebound in bond yields. One result: a shift in equity factor leadership. U.S. value has recovered and momentum stumbled. Does this factor rotation have staying power? We think it is too early to call for a value revival – and prefer defensive equity factors such as minimum volatility and quality as growth slows and trade protectionism persists.

Mike Pyle

Global Chief Investment Strategist — BlackRock Investment Institute

Elga Bartsch

Head of Macro Research — BlackRock Investment Institute

Kurt Reiman

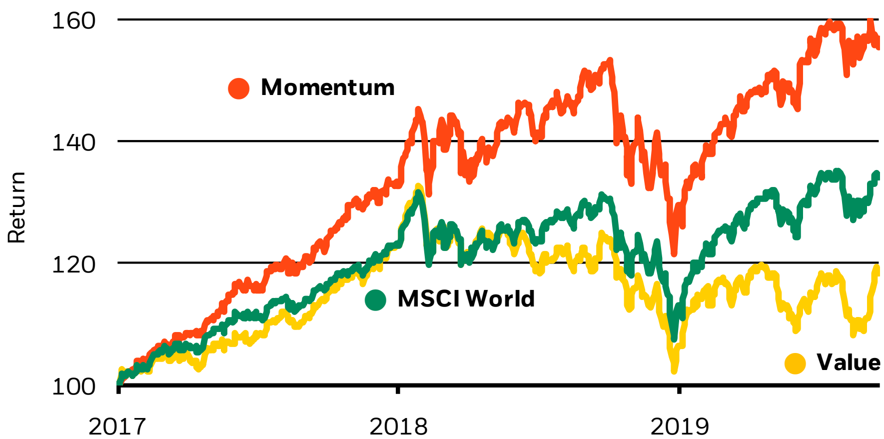
Chief Investment Strategist for Canada — BlackRock Investment Institute

Beata Harasim

Senior Investment Strategist — BlackRock Investment Institute

Chart of the week

Performance of MSCI World Momentum vs. Value indexes, 2017-2019



Past performance is not a reliable indicator of current or future results.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2019. Notes: The indexes used are MSCI World Momentum Index, MSCI World Enhanced Value Index and MSCI World Index. The performance is on total returns basis, in U.S. dollar terms and rebased to the start of 2017.

Examining recent equity market movements through the lens of factors – or broad and persistent drivers of returns – uncovers some stark trends. Momentum strategies – focusing on stocks trending higher in price – have dramatically outperformed since 2017. The value factor, which focuses on companies that are trading cheap relative to fundamentals such as earnings, has lagged significantly. Yet momentum has hit some turbulence this month, with value showing signs of life. See the chart above. Note that this measure of value is sector-neutral; it therefore does not overweight traditional "value" sectors such as energy, which have rallied strongly since late August. We see the recent sharp rebound in U.S. bond yields as a major driver of this reversal.

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What lies behind the recent factor reversal – and will it persist? We see geopolitics as a key driver. Trade tensions and broader geopolitical uncertainties have been stoking greater macro uncertainty and recession fears, as we wrote in our midyear outlook. This sentiment had driven bond yields to historical lows and helped trigger an inversion of the U.S. yield curve in late August, with longer term yields falling below short-term yields. Signs of a temporary lull in U.S.-China trade tensions – with an agreement to restart trade talks – coupled with upside surprises in economic data led to a reversal of some of these market moves. Long-term rates recalibrated and the yield curve steepened. A jump in the crude oil price also gave a boost to cheap energy stocks.

Value companies tend to perform better when the yield curve is steepening and when the outlook for the economy is improving. The momentum factor tends to perform well in stable macro environments. In today's low-growth economy, momentum has tended to center around "secular growth" plays in the information technology sector and dividend paying consumer staples stocks. The latter tend to be correlated with duration, or interest rate exposure, leaving them vulnerable to bond yield spikes. Also creating conditions for the factor rotation: Market positioning in both factors looked to have become stretched heading into the recent market shakeup. Investors had piled into momentum stocks, leaving many value equities unloved. Before the reversal, the value factor had been trading near the bottom of its historical valuation range, so may have been overdue for a correction. In contrast, momentum had been trading near the top of its historical valuation ranges.

The reversal has not changed our overall outlook. We anticipate slowing economic activity but not an imminent U.S. recession – and believe markets may still be pricing in too much additional Federal Reserve easing after last week's second "insurance cut" in two months. We see the U.S. protectionist push persisting, with little chance of a comprehensive U.S.-China trade deal in the near term. The growth outlook does cast a shadow on corporate profit margins. We expect a material corporate margin contraction in 2019 – a typical late-cycle pattern. This backdrop is behind our call for greater portfolio resilience. In equities we have turned more cautious on momentum and prefer more defensive factors such as quality and minimum volatility. And we see an important role for government bonds as portfolio stabilizers in risk-off episodes.

Market backdrop

A perceived easing of U.S-China tensions and an attack on Saudi Arabia's oil infrastructure show how geopolitical frictions are key market drivers. Major central banks have taken a dovish stance — the Fed last week cut rates in line with market expectations, following the European Central Bank's broad stimulus package. Yet the Fed's noncommittal stance on its future policy path reinforces our view that there are limits to how much monetary easing can be delivered in the near term. Monetary policy is no cure for the weaker growth and firmer inflation pressures associated with sustained trade tensions.

Assets in review

Selected asset performance, 2019 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.

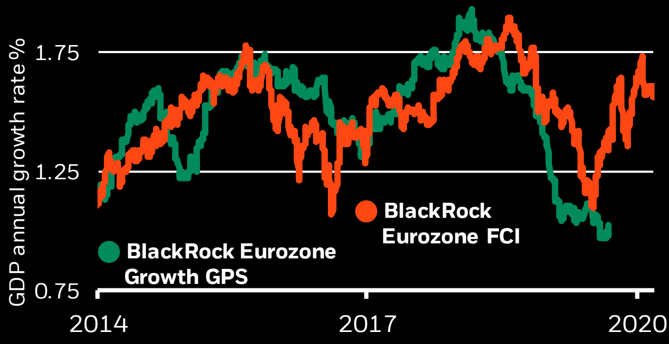
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2019. Notes: The dots show total returns of asset classes in local currencies. Exceptions are emerging market (EM), high yield and global corporate investment grade (IG), which are denominated in U.S. dollars. Indexes or prices used: spot Brent crude, MSCI USA 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. and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

The European Central Bank (ECB) broadly met or exceeded consensus stimulus expectations at its September meeting. Easier monetary policy is a key reason why we believe the risk of a near-term recession is limited. The ECB cut the deposit facility rate by 10 basis points to -0.5% and restarted its asset purchase programme at €20 billion a month – and tied it to forward guidance that promises asset purchases until inflation makes a meaningful move towards the ECB's 2% inflation target. The ECB now has to vote to bring quantitative easing to an end. The chart shows how our Financial Conditions Indicator implies a higher level of growth than our Eurozone Growth GPS. There are some valid reasons to believe easy financial conditions cannot fully transmit to business capital expenditure and growth. The uncertainty created by the trade conflict is one. But loose financial conditions should still be able to offer some support to the economy – and perhaps a modest boost.

Signs of support

BlackRock Eurozone Growth GPS and FCI, 2014-2020



Sources: BlackRock Investment Institute and Bloomberg, September 2019. Notes: The chart shows the rate of GDP growth implied by our financial conditions indicator (FCI), based on its historical relationship with our Growth GPS, shifted forward six months. The BlackRock Growth GPS 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 Protectionist push

- U.S.-China tensions ostensibly eased ahead of a new round of trade talks in October. We don't see any short-term deal solving long-term strategic issues such as technological dominance and implications for national security.
- Persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle — a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- The attack on Saudi Arabia's oil facilities shows how geopolitical risks can materialize in multiple ways. A prolonged oil price shock, along with tariffs, could deepen concerns around the risk of lower growth and firmer inflation pressures.
- **Market implication**: We favor reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- The record-long U.S. economic expansion is supported by healthy household spending and looks unlikely to morph into a deeper downturn any time soon.
- The Fed cut rates by a quarter-point for a second time since the financial crisis, yet stopped short of bolder actions. This supports our view that the market's easing expectations are excessive. The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct one-off impact of tariffs. In the longer term the resulting hit to production capacity could also be inflationary, complicating the case for policy easing.
- We believe policymakers should lay the groundwork for a credible plan to navigate the next economic shock that includes unprecedented coordination between monetary and fiscal measures. We lay out the contours of such a framework in our latest Macro and market perspectives. Absence of a credible plan is contributing to market anxiety, and adding to the rush into the perceived safety of government bonds.
- Chinese authorities have cut bank reserve requirements, lowered private sector borrowing costs and boosted infrastructure spending. Yet the stimulus remains limited, with a focus still on shoring up the financial system.
- **Market implication:** We like U.S. equities and EM debt. We are overweight eurozone government bonds: a relatively steeper yield curve brightens their appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- A sharp spike higher in U.S. money market rates — a cornerstone of the financial system — jolted market participants and highlighted the importance of portfolio resilience.
- The underperformance of momentum and outperformance of value show the importance of minimizing portfolio exposure to pockets of the market where pricing appears stretched.
- **Market implication**: Government bonds play an important role in building portfolio resilience – even at low yield levels – both on a tactical basis and in long-term portfolios.

Week ahead

Sept. 23 — September U.S. and eurozone Markit flash manufacturing and services Purchasing Managers' Index (PMI) data will provide clues about the path of global economic growth, including to what extent global trade tensions are further spilling over into manufacturing sectors and whether service sector strength can persist in providing a growth boost.

Sept. 24 —The September U.S. consumer confidence index will offer a signpost on U.S. consumer health. U.S. consumer spending – making up over two thirds of the U.S. economy – has been holding up and is key for U.S. and global growth. U.S. consumers have been supporting growth in the face of manufacturing headwinds, slowing job growth and tariffs.

Asset views

Asset class		View	Comments
Equities	**U.S.**	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective, we prefer defensive factors such as quality and minimum volatility as growth slows and trade protectionism persists.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	**U.S. government bonds**	▼	We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis' tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲	The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for eurozone investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We like EM bonds for their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina's woes) and in countries not directly exposed to U.S.-China tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing. We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

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