



WEEKLY COMMENTARY • AUG. 12, 2019

Key points

- 1 An escalation in U.S.-China tensions has roiled global financial markets, reinforcing our call to build portfolio resilience.
- 2 Weak activity data exacerbated declines in global risk assets including stocks and most commodities. Perceived safe-haven assets rallied.
- 3 China's industrial output and retail sales data this week are expected to moderate after unexpected gains in the previous month.

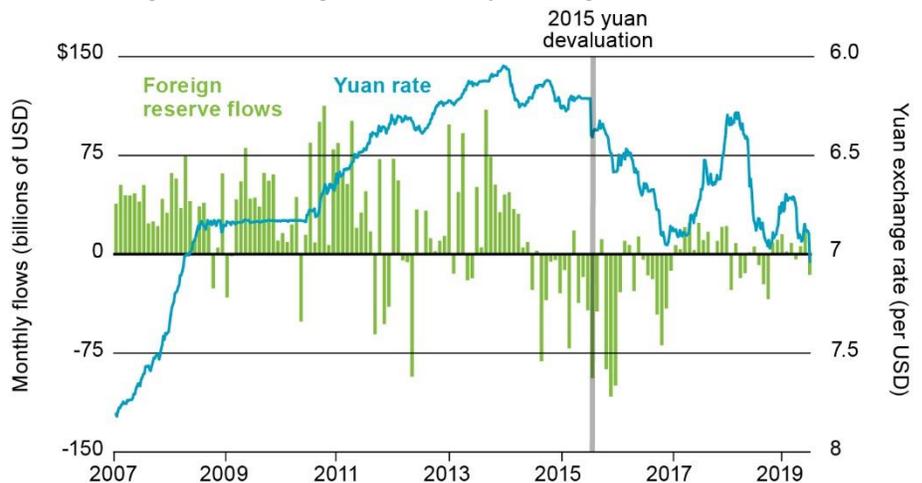
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1 How to navigate escalating trade disputes

The recent escalation in U.S.-China tensions reinforces our view that trade and geopolitical frictions have become the key driver of the global economy and markets. We stress the importance of portfolio resilience in this environment, yet view the decisively dovish shift by global central banks as helping extend the global expansion.

Chart of the week

China's foreign reserve changes and currency exchange rate, 2007-2019



Sources: BlackRock Investment Institute, with data from the People's Bank of China (PBOC) and Refinitiv Datastream, August 2019. Notes: Flows in China's foreign reserves are represented by monthly changes in PBOC's foreign reserves. The yuan exchange rate is represented by the currency's spot closing rate versus the U.S. dollar. The vertical axis on the yuan rate is flipped so that a downward move in the line represents a weaker yuan versus the dollar.

U.S. President Donald Trump announced a 10% tariff from next month on the \$300 billion of Chinese imports not already subject to tariffs. This triggered a wave of tit-for-tat retaliations. China let its currency breach the psychologically important 7-per-U.S. dollar level – a departure from the People's Bank of China (PBOC)'s usual practice of stabilizing the yuan when it's under pressure. This sparked memories of the 2015 yuan devaluation that rocked global markets. Yet we do not expect a repeat. Capital outflows from China hit historic levels in 2015, but have ebbed since, with better curbs in place. And we see the deliberate nature of PBOC's latest move stemming fears of uncontrolled devaluation. Spillover to other EM currencies has been subdued versus 2015. We see Beijing allowing the yuan to fall further, but in a controlled manner. Other recent tit-for-tat actions: The U.S. designated China a "currency manipulator," China said it would stop buying U.S. agricultural goods, and the U.S. delayed a decision to loosen restrictions on Chinese telecoms giant Huawei.



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## Focus on portfolio resilience

Trade disputes extend beyond the U.S. and China, and trade policy has increasingly become a tool that global governments use to pursue political objectives. The latest example: A row between Japan and South Korea over wartime compensations has morphed into an intensifying – and likely long-lasting – trade and technology dispute. Europe could be the next front of the global trade war, as European governments step up taxation of U.S. tech companies. See our [geopolitical risk dashboard](#) for more.

Rising macro uncertainty has contributed to a dovish tilt by global central banks. This stems downside risks to the economy and reinforces our view that despite a downgrade to our growth outlook, the global expansion can run on for longer. The latest shot of monetary easing came from central banks in New Zealand, Thailand and India. The trio surprised the markets, cutting rates by more than expected last week. The accommodative stance of central banks underscores our still-positive view on risk assets. This includes income opportunities such as local-currency EM debt of countries with low exposure to U.S.-China trade tensions.

The market turbulence underscores our call for portfolio resilience. Government bonds have lived up to their promise as portfolio stabilizers, even with U.S. 10-year Treasury yields now near three-year lows. German government bond yields have also declined – though not as drastically. This illustrates another of our key views: Core European bonds may offer a thin cushion against stock market selloffs as yields approach an [effective lower bound](#). We like European sovereigns on a tactical basis, notably those from southern-tier countries, as we expect the European Central Bank to unleash further stimulus. By contrast, we see market expectations of aggressive Fed easing as excessive, given limited near-term recession risks. We see inflation-linked bonds offering buffers against equity drawdowns and underappreciated inflation risks. We prefer the U.S. equity market for its still longer-term reasonable valuations and a concentration of high-quality companies. We favor the min-vol factor, which has tended to do well during economic slowdowns.

## 2 Week in review

- Global stocks tumbled before paring some losses. Most commodities sold off. Benchmark Brent crude oil prices dropped to the lowest since the start of the year. Perceived safe-haven assets such as gold, Japanese yen and government bonds rallied. German long-maturity bond yields touched record lows. Sovereign yield curves flattened significantly.
- The League, part of Italy's ruling coalition, pulled its support for the government, triggering a potential early election this year. The UK economy shrank for the first time since 2012 in the second quarter. Eurozone's manufacturing downturn deepened. German and French industrial output declined sharply in June.
- China's services sector grew at the slowest pace in July in five months. Beijing reported better-than-expected trade data, but the export sector remains under pressure from increasing U.S.-China trade tensions.

### Global snapshot

Weekly and 12-month performance of selected assets

Equities	Week	YTD	12 Months	Div. Yield
<b>U.S. Large Caps</b>	-0.4%	17.8%	4.4%	2.0%
<b>U.S. Small Caps</b>	-1.3%	13.1%	-9.2%	1.7%
<b>Non-U.S. World</b>	-1.3%	8.8%	-4.4%	3.3%
<b>Non-U.S. Developed</b>	-1.1%	9.8%	-4.1%	3.5%
<b>Japan</b>	-1.1%	6.9%	-5.4%	2.5%
<b>Emerging</b>	-2.2%	3.7%	-6.4%	3.0%
<b>Asia ex-Japan</b>	-2.7%	2.7%	-8.3%	2.7%

Commodities	Week	YTD	12 Months	Level
<b>Brent Crude Oil</b>	-5.4%	8.8%	-18.8%	\$ 58.53
<b>Gold</b>	3.9%	16.7%	23.5%	\$ 1,497
<b>Copper</b>	0.5%	-3.5%	-7.6%	\$ 5,755

Bonds	Week	YTD	12 Months	Yield
<b>U.S. Treasuries</b>	0.9%	7.1%	9.4%	1.7%
<b>U.S. TIPS</b>	1.0%	8.0%	7.1%	1.8%
<b>U.S. Investment Grade</b>	0.6%	12.0%	11.8%	3.0%
<b>U.S. High Yield</b>	-0.3%	9.9%	5.8%	6.1%
<b>U.S. Municipals</b>	0.6%	7.1%	8.5%	1.7%
<b>Non-U.S. Developed</b>	1.0%	5.8%	5.9%	0.5%
<b>EM \$ Bonds</b>	0.8%	13.5%	12.8%	5.2%

Currencies	Week	YTD	12 Months	Level
<b>Euro/USD</b>	0.8%	-2.4%	-2.8%	1.12
<b>USD/Yen</b>	-0.9%	-3.6%	-4.9%	105.68
<b>Pound/USD</b>	-1.0%	-5.7%	-6.1%	1.20

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Source: Refinitiv Datastream. As Aug. 9, 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

**Aug 13**

German consumer price index, ZEW economic sentiment

**Aug 15**

U.S. retail sales

**Aug 14**

China industrial output, urban investment, retail sales; eurozone second-quarter gross domestic product

**Aug 16**

University of Michigan survey of consumers; Organization of Petroleum Exporting Countries (OPEC) monthly oil market report

Chinese data will be in focus this week. Both industrial production and retail sales for July are expected to moderate slightly following the uplift in the previous month. Markets could be vulnerable if the data miss expectations, given the weaker investor sentiment and soft manufacturing business surveys globally in recent weeks. Policy stimulus has been supportive, and we see the potential for additional stimulus taken up by the Chinese government to offset the impact of increasing trade tensions – likely through further fiscal easing.

## Asset class views

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

	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 like momentum and min-vol, but have turned neutral on quality due to elevated valuations.
	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 across the board, 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 have downgraded U.S. Treasuries to underweight from neutral. Market expectations of Fed easing seem excessive, leaving us cautious on Treasury valuations, particularly in shorter maturities. Yet we still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	▲	Muni valuations are on the high side, but the asset class has lagged the U.S. Treasuries rally. Favorable supply-demand dynamics, seasonal demand and broadly improved fundamentals should drive muni outperformance. The tax overhaul has also made munis' tax-exempt status more attractive.
	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	▲	We have upgraded European government bonds to overweight because we expect the ECB to deliver – or even exceed – stimulus expectations. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential. A relatively steep yield curve is a plus for eurozone investors.
	European credit	—	We have upgraded European credit to neutral. Fresh ECB policy easing should include corporate bond purchases. The ECB's "lower for even longer" rate shift should help limit market volatility. 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 have upgraded EM bonds to overweight on 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 believe local-currency markets have further to run and prefer them over hard-currency markets. We see opportunities in Latin America and in countries not directly exposed to U.S.-China trade 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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