Weekly commentary

BlackRock

May 11, 2020

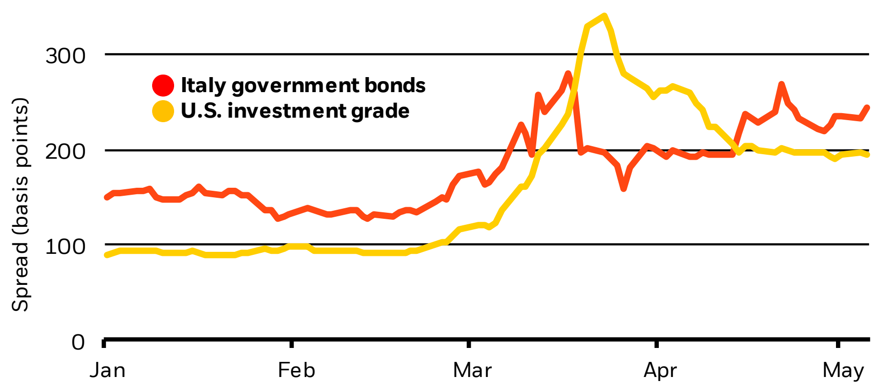
Europe bond outlook under review

- A surprise decision by Germany's constitutional court may undermine central bank independence, clouding the outlook for European bonds.
- Markets seesawed as some economies start to lift lockdowns, while still rising infections and grim activity data weighed on sentiment.
- A trio of U.S. surveys on manufacturing, small businesses and consumers could offer insights into the impact of the virus shock.

A decision by the German constitutional court last week could potentially undermine the independence of the European Central Bank (ECB) – and threaten to fuel fragmentation within the euro area in the long run. This comes as the ECB's actions to cushion the pandemic's fallout already looked meek compared with the Federal Reserve's. As a result, we are reviewing our overweight on euro area peripherals, or government bonds from southern-tier nations.

Chart of the week

Italian government bond, U.S. investment grade yields vs. risk-free rates



Sources: BlackRock Investment Institute, with data from Refinitiv, May 2020. Notes: The orange line represents the yield spread between 10-year Italian and German government bonds, calculated based on the are the Refinitiv Datastream 10-year government bond benchmark indexes for Italy and Germany. The yellow line represents the yield spread between U.S. investment grade credit and Treasuries, based on the option-adjusted spread of the Bloomberg Barclays U.S. Credit Index.

The German court gave the ECB three months to justify its 2-trillion-euro bond purchase program to the German parliament. Otherwise the Bundesbank – the ECB's largest shareholder and bond buyer – would have to pull out of the program, the court said. The ruling put a spanner into the works of the ECB's "whatever-it-takes" commitment – at a time when effective execution of policies is critical to safeguard the economy against damages from the coronavirus shock. As evidence of the vulnerability in the euro area's hardest-hit economies, the yield spread between Italy's government bonds and their German counterparts has been *widening* since late March despite the ECB's stepped-up purchase program. In contrast, the U.S. investment grade credit spread declined from its March peak and has steadied since mid-April as the Fed's pandemic response allayed credit concerns. See the chart above.

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We have seen nothing short of a policy revolution in response to the coronavirus outbreak – in terms of speed, size and monetary-fiscal coordination. The successful execution of policies and programs is key – and the German court ruling may be a cautionary tale of how execution can be scuppered. Explaining itself to the German parliament shouldn't be a problem for the ECB. Yet having to do so undermines its independence, a precondition for its "whatever-it-takes" stance. This is partly a consequence of the blurring of boundaries between monetary and fiscal policies – and particularly problematic in the euro area due to the lack of a joint fiscal authority. We had highlighted the crucial role of proper guard rails around policy coordination in Dealing with the next downturn.

The ruling is unlikely to have immediate consequences for the ECB's monetary policy and has led the European Union's top court to state that it alone had the power to rule on whether EU bodies were in breach of the bloc's rules. Yet it could create longer-term issues for the central bank and the euro area. Why? It highlights legal uncertainty on the Bundesbank's ability to support ECB policies. The German court drew red lines on two key parameters – the capital share of each member central bank of the ECB and a 33% cap on buying any country's debt – potentially limiting the size of the ECB's bond purchases. Undermining the ECB's independence could pave the way to renewed euro area fragmentation, the risk currently topping BlackRock's Geopolitical risk indicator. Market confidence in the ECB's ability to contain crises could be dented. This will make it even harder to ensure sovereign debt sustainability in the coming years, especially in the periphery, in our view.

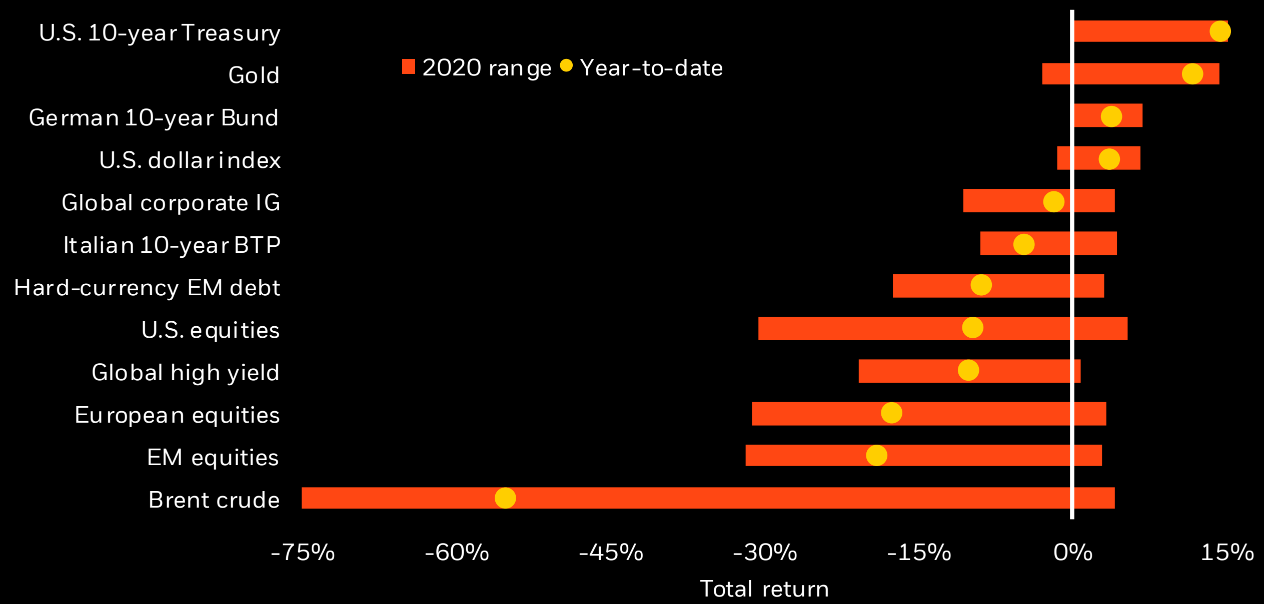
The bottom line: We are putting our view on euro area peripheral bonds on review despite relatively attractive valuations, as the German court case challenges the ECB's independence. One offset to this risk: The ECB may up the scale of its bond purchases in coming months, which would support peripherals and euro area credit. Over the strategic horizon, we already see a diminished case for nominal developed market bonds due to the market reaction and policy response to the outbreak. Yields have fallen close to lower bounds, reducing return expectations and the ballast properties that traditionally help nominal government bonds cushion portfolios against risk-off episodes. The picture may look even gloomier over coming years if supply chain changes pick up pace, monetary policy is more accommodative and inflation risk rises. The court ruling offers a glimpse of challenges to effective policy execution – and adds to reasons to be wary of nominal government bonds.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the priorities are 1) policy execution to ensure households and businesses actually receive the pledged funding; and 2) avoiding policy fatigue before the shock has passed. Markets have been torn between optimism on the tentative re-opening of some economies and caution on the still grim economic data. The U.S. administration, meanwhile, is making a calculus between the perceived political benefits of being tough on China and the risk of renewed stock market volatility.

Assets in review

Selected asset performance, 2020 year-to-date and range



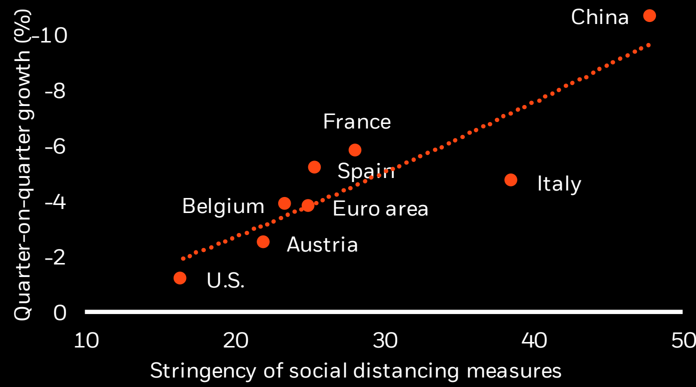
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar 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., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

Initial estimates of GDP growth for Q1 2020 were below consensus across the board. The impact in the euro area was deeper than in the U.S., which went into lockdown later. The growth data suggest that the depth of drop in activity has gone hand in hand with the stringency of the lockdown. Italy is a slight outlier – the economy seems to have fared better than the severe lockdown would have implied. Consensus expectations point to a further – deeper – drop in output in Q2 2020, even if lockdown measures are gradually lifted in the next few weeks. This would be consistent with the current shock being akin to a large-scale natural disaster that severely disrupts near-term activity. But a recovery should follow once the lockdown measures are eased. We believe it is time to look beyond the depth of the contraction and assess how long it might last. As countries lay out plans to slowly restart, we will get a better sense of how long it might take. Success will not just be about restarting the economy and containing the virus – but how governments balance both objectives.

Covid containment

Q1 GDP growth estimates and social distancing stringency



Sources: BlackRock Investment Institute and the University of Oxford, with data from Haver Analytics, May 2020. Notes: The chart shows a measure of how strict lockdown measures are in the countries shown, and official Q1 quarter-on-quarter GDP growth estimates. The stringency score is taken from the Oxford COVID-19 Government Response Tracker. This collects publicly available information on 17 indicators of government responses.

Investment themes

1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 – but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions as stringent shutdown measures take effect. A key question: Can such measures be lifted without a major second wave of cases?
- The nature of the activity rebound will depend on the path of the outbreak, delivery of policy response and potential changes to consumer and corporate behaviors. Success will not just be about restarting the economy and containing the virus – but balancing both objectives.
- **Market implication**: We are mostly sticking to benchmark holdings on an asset class level; prefer credit over equities; and favor rebalancing into the risk asset decline.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets is taking shape, particularly in the U.S. The U.S. unemployment rate hit its highest level since the Great Depression in April, underscoring the need for effective policy implementation.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the coronavirus shock and ensuring markets function properly. We could see its balance sheet more than double to $11 trillion by year end to support the fiscal response. The U.S. Treasury smashed records by setting out a $3 trillion borrowing plan in its quarterly refunding to fund the response – showing the blurring of lines between monetary and fiscal policy.
- A German constitutional court's ruling challenges central bank independence and threatens the integrity of the euro area in the long run. This took place just as European Central Bank data showed aggressive buying of Italian bonds to limit the widening of yield spreads, which remain near this year's peaks. It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- European Union leaders have agreed on the need for an emergency fund of at least 1 trillion euros but are still sorting out details – reinforcing the relative disappointment on policy action in the euro area.
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments (i.e by relieving bank capital and collateral requirements).
- We see risks of implementation and policy exhaustion. Next rounds of U.S. fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit and dividend income in selected equity sectors.

3 Resilience rules

- Portfolio resilience has to go beyond nominal government bonds and consider alternative return sources that can provide diversification.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability and Chinese assets into investment processes.

Week ahead

May 12 U.S. NFIB Small Business Economic Trends survey; China, U.S. consumer price index

May 14 U.S. weekly initial jobless claims

May 15 Univ. of Michigan surveys of consumers; U.S. retail sales, Empire State Manufacturing Survey, industrial production; China industrial output, retail sales; euro area flash estimate GDP

A trio of surveys in the U.S. – on small business, manufacturing and consumers – could provide important insights on the impact of the pandemic. Markets will watch out for any cracks in the financial system and elsewhere in the economy as virus infections climb. Data from China, including total social financing, could shed light on the recovery of the manufacturing and consumer sectors – or lack thereof – as the economy has cautiously re-opened.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, May 2020

Asset	Underweight / Neutral / Overweight
Equities	We previously downgraded global equities to neutral. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room. We favor rebalancing back toward benchmark weights as markets fall.
Credit	We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.
Government bonds	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.
Cash	We maintain our neutral position on cash for risk mitigation. 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: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2020

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
Equities	Euro area	■		We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
Equities	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
Equities	Emerging markets			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
Equities	Asia ex-Japan		■	We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
Equities	Momentum			We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
Equities	Value	■		We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
Equities	Minimum volatility		■	We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
Equities	Quality		■	We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income	U.S. Treasuries		■	We like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
Fixed Income	Treasury Inflation-Protected Securities			We are neutral on TIPS. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
Fixed Income	German bunds	■		We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
Fixed Income	Euro area peripherals		■	We are reviewing our overweight in euro area peripheral government bonds. A recent German constitutional court's ruling could potentially limit the size of the European Central Bank's bond buying program.
Fixed Income	Global investment grade		■	We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
Fixed Income	Global high yield		■	We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities.
Fixed Income	Emerging market – hard currency			We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced.
Fixed Income	Emerging market – local currency			We are neutral on local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon income.
Fixed Income	Asia fixed income		■	We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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