Weekly commentary

BlackRock

Sept. 21, 2020

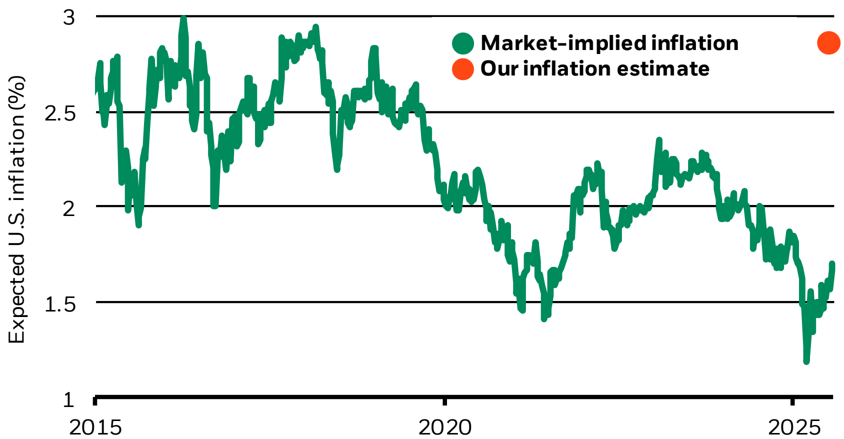
Greater inflation risks ahead

- Three new forces are set to lift inflation beyond what markets are currently expecting in the years ahead, reversing a decade of subdued price rises.
- Market volatility has returned after months of steady advances in risk assets, and could stay elevated as the U.S. election draws near.
- Markets will focus on a slew of purchasing managers' index data this week to gauge the latest business sentiment.

We see a higher inflation regime in the medium term after a decade of inflation persistently undershooting central bank targets. Three new forces are at play: rising global production cost, new central bank policy frameworks that allow for inflation overshoots and greater political pressure for keep rates low in a high-debt environment. See our latest *Macro and market perspectives* for more.

Chart of the week

U.S. inflation market pricing vs. our estimate, 2015-2025



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute and the Federal Reserve with data from Refinitiv Datastream, September 2020. Notes: The chart shows a market measure of what five-year inflation expectations based on the consumer price index (CPI) will be in five years' time. We show it using the five-year/five-year inflation swap. The line is shifted forward five years. The orange dot shows the BlackRock Investment Institute's current estimate of average U.S. CPI inflation for the same five-year period of 2025-2030.

We expect annual growth in the U.S. consumer price index (CPI) to average in the range of 2.5% to 3% between 2025 and 2030, as the chart shows. This is broadly consistent with inflation moderately above the Fed's 2% target (CPI inflation tends to run above the Fed's preferred gauge based on the personal consumption expenditures, or PCE, price index), and a jump from current market-implied inflation. Rising global production costs are the trigger. The Covid shock is driving up costs in contact-intensive services, and could speed up deglobalization and the remapping of supply chains for greater resilience against a range of potential shocks. Less offshoring could give domestic workers more bargaining power on wages, especially in places where the political pendulum is swinging toward addressing inequality. So-called superstar companies – many in the tech sector – could gain greater ability to pass on higher production costs to customers, having achieved dominant market shares.

Jean Boivin
Head — BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Mike Pyle
Global Chief Investment Strategist – BlackRock Investment Institute

Nicholas Fawcett
Member of Economic and Markets Research group – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on global economy, markets, geopolitics and portfolio construction.

BlackRock Investment Institute

Major central banks are evolving their policy frameworks and explicitly aim to let inflation overshoot their targets. After having persistently undershot its inflation goal, the Federal Reserve has adopted a new policy framework to deliberately push inflation above target to make up for past misses. The central bank also said it will be concerned only by the "shortfall" from full employment, with tight labor markets no longer a consideration. With the help of higher production costs, we expect the Fed to succeed in lifting inflation above 2%. The Fed essentially has given up two key reasons to raise rates that it previously had: inflation on track to overshoot the target and overheated labor markets. This reinforces our views about upside inflation risks –especially with rising political pressure to keep interest rates ultra-low.

The third force is the joint monetary-fiscal policy revolution we have just experienced – a necessary response to the Covid shock. We see a risk scenario where major central banks lose grip of inflation expectations relative to their target levels.This is not our base case – but could happen without proper guardrails and a clear exit plan from current stimulus measures. The blurring of fiscal and monetary policy means the decision to start tightening monetary policy will be more politicized. Significantly higher debt loads mean debt servicing costs will rise when monetary policy is tightened. The less tangible – but no less real – risk of loosening the grip on inflation expectations may be more politically appealing. On the flip side, a premature withdrawal of fiscal support — a risk we see in the U.S. – could forestall the reflationary path that is our base case.

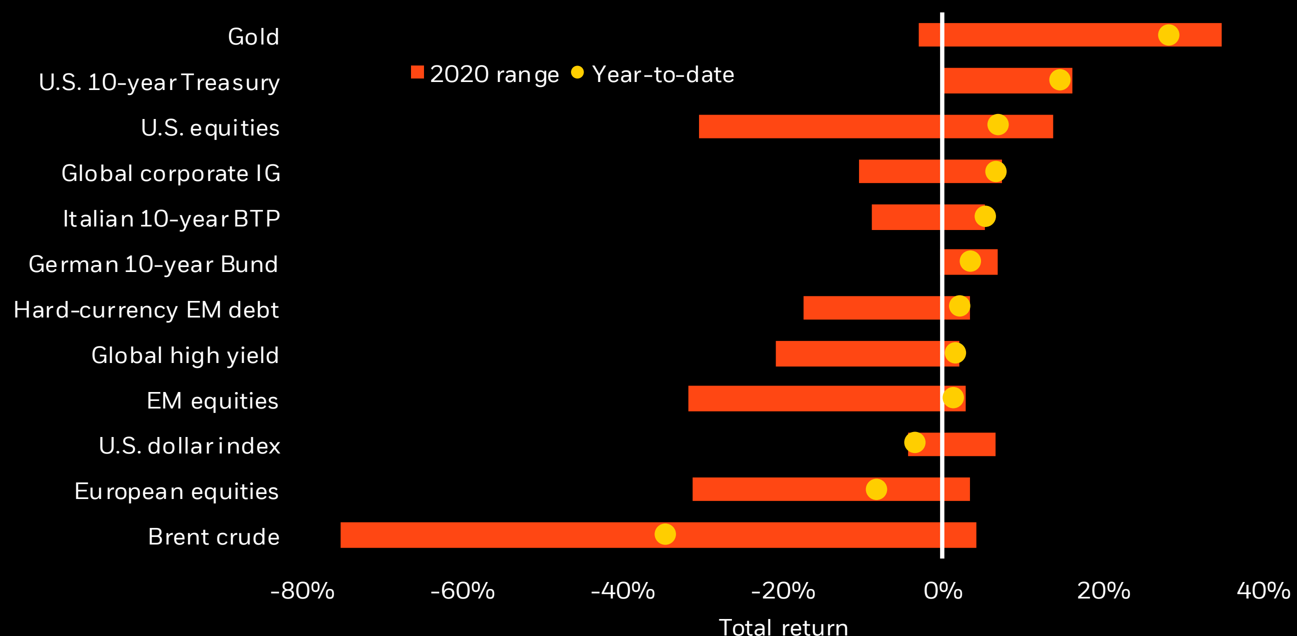
Our inflation outlook represents an important shift in the economic backdrop for investing. Higher inflation is not yet reflected in market prices, opening a window of opportunity for long-term investors. Once higher inflation appears, it's likely too late for investors to react – markets will have already moved to price in higher inflation expectations. In unconstrained portfolios, we are overweight inflation-linked bonds and underweight developed market nominal government bonds on a strategic basis. Building inflation protection comes with a cost when there is little inflation around, but it's less costly now as the ballast role of nominal government bonds has diminished with their yields near effective lower bounds. We also like real assets, such as real estate, as potential diversifiers and sources of resilience. Selected equities may provide some inflation protection as well, complementing less liquid inflation-linked bonds and real assets. We prefer companies with strong market positions and the ability to pass on higher costs.

Market backdrop

Activity has started to normalize around the globe, albeit at different paces due to varying virus dynamics. Market volatility is returning after months of steady advances in risk assets, and we see elevated volatility ahead of the November U.S. election. In addition, negotiations of a new U.S. fiscal package are dragging on, the pandemic is still spreading in many countries, and U.S.-China tensions are running high.

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, September 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 therest 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

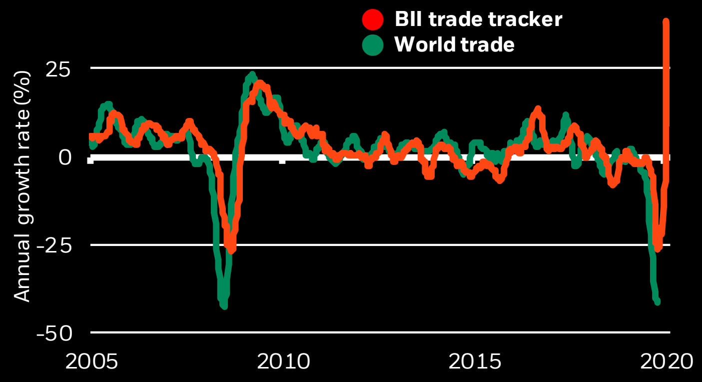
The Covid-19 shock caused a plunge in trade activity, but the tide may be turning. Our real-time trade tracker – showing where trade volumes may stand in three months' time – has rebounded into positive territory. This implies trade volumes are close to pre-Covid levels.

The reopening of economies is a major driver of trade revival. The rebound has been led by China thanks to its early emergence from lockdowns. Increased demand for medical equipment also helped. Trade tensions have been steady, but weaker Chinese imports from the U.S. could be a source of political tension as the U.S. election nears. In the euro area – a more open economy than the U.S. – trade data is also improving after a sharp drop during the activity shutdown.

The weakness in the U.S. dollar may also have helped boost global trade volumes, particularly as it is driven by improving risk appetite rather than a change in interest rate spreads.

Favorable trade winds

BII trade tracker and global trade growth, 2005-2020



Sources: BlackRock Investment Institute, CPB World Trade Monitor, U.S. Bureau of Economic Analysis and World Steel Association, with data from Refinitiv Datastream, Sept. 2020. Notes: The chart shows the three-month annualized percentage change in real global goods trade volume (in green) and a real-time "nowcast" (in orange) of where that trade volume may stand in three months' time. The nowcast uses principal component analysis based on 50 indicators, such as exports from South Korea and Taiwan, German manufacturing surveys and the export order components of global PMIs, to track global trade activity. Forward-looking estimates may not come to pass.

Investment themes

1 Activity restart

- The activity restart has broadened, and is running ahead of expectations in developed markets. Yet it is moving at different speeds across countries, driven by differences in virus dynamics - stalling or retrenching in countries that experienced an increase in virus infection rates.
- We see localized restrictions as the main virus control approach over coming month, and a return to full national lockdowns as unlikely. Fatality and hospitalization rates per infection have dropped even with higher case counts.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-Covid world could be painful, especially for contact-intensive sectors.
- The risk of fiscal fatigue is crystallizing in the U.S., raising concerns about the recovery running out of steam. Negotiations on extending fiscal support have stalled, with an increasingly binary potential outcome: a sizable package or nothing at all before the Nov. 3 election.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield – in both strategic and tactical portfolios. We have a preference for cyclical assets in Europe.

2 Policy revolution

- The joint fiscal-monetary coordination in response to the Covid-19 shock is nothing short of a policy revolution. The Federal Reserve is leading major central banks in evolving policy frameworks to explicitly aim to let inflation overshoot targets – a desirable move in the current environment but the lack of proper guardrails raise concerns.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows.
- Europe's historic recovery fund will introduce mutualized debt and create jointly issued European bonds that can compete with other perceived safe-haven assets. It still needs approvals by the European and national parliaments.
- The blurring of monetary and fiscal policy means that it is crucial to have proper guardrails around policy coordination. In their absence we see a risk that major central banks could lose grip of inflation expectations relative to their target levels. Combined with other structural changes accelerated by Covid-19 such as deglobalization, it could lead to a higher inflation regime in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions in technology stocks.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We believe countries, sectors and companies will make a comeback as diversifiers in a more fragmented world, offering resilience to real economy trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. Investors should consider alternative return sources that can provide diversification, such as private markets.
- 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 sustainable assets, private markets and deliberate country diversification for strategic portfolios. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops, and generally prefer developed markets over the emerging world.

Week ahead

Sept. 22 Euro area flash consumer confidence

Sept. 23 Flash composite PMI for Japan, euro area, the UK and U.S.

Sept. 24 German ifo Business Climate Index

Sept. 25 UK GfK consumer confidence

A spate of PMI data this week could help market participants assess the pace of the activity restart. So far the restart has been faster than expected in developed markets, but is moving at different speeds across countries driven by different virus dynamics. A potential focal point: Is the recent rise in Covid cases in parts of the euro area weighing on sentiment?

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2020

Asset	Strategic view	Tactical view	
Equities	Neutral	Neutral	We have turned neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall . We like the quality factor for its resilience and favor Europe among cyclical exposures.
Credit	Neutral	+1	We have turned neutral on credit on a strategic basis because we see investment grade (IG) spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, we strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
Govt bonds	-1	Neutral	The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. Such low rates reduce the asset class's ability to act as ballast against equity market selloffs. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation suppresses yields.
Cash		Neutral	We are neutral on cash. Holding some cash makes sense as a buffer against supply shocks that could drive both stocks and bonds lower.
Private markets	Neutral		Non-traditional return streams, including private credit, have the potential to add value and diversification. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures but valuations and inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, September 2020. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Change in view

Previous New

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

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. Risks of fading fiscal stimulus and an extended epidemic are threatening to derail the market's strong run. Renewed U.S.-China tensions and a divisive election also weigh.
	Euro area			We are overweight European equities. The region is exposed to a cyclical upside as the economy restarts, against a backdrop of solid public health measures and a galvanizing policy response.
	Japan			We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
	Emerging markets			We are underweight emerging market equities. We are concerned about the pandemic's spread and see less room or willingness for policy measures to cushion the impact in many – but not all – countries.
	Asia ex-Japan			We hold Asia ex-Japan equities at neutral. Renewed U.S.-China tension is a risk. China's goal to balance growth with financial stability has led to relatively muted policy measures to cushion the virus fallout.
	Momentum			We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold.
	Value			We are neutral on value. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance.
	Minimum volatility			We hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.
	Quality			We keep our strong overweight on quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy.
Fixed Income	U.S. Treasuries			We still like U.S. Treasuries. Long-term yields are likely to fall further than other developed market peers, even as low rates reduce their ability to cushion against risk asset selloffs.
	Treasury Inflation-Protected Securities			We are neutral on TIPS. A huge decline in rates makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
	German bunds			We remain underweight bunds as current yield levels provide little cushion against major risk events. Also, potential issuance related to the proposed EU recovery fund could compete with bunds for investment.
	Euro area peripherals			We are overweight euro area peripheral government bonds despite recent outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions.
	Global investment grade			We downgrade investment grade credit to neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
	Global high yield			We increase our overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency			We are underweight hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced.
	Emerging market – local currency			We have downgraded local-currency EM debt to underweight. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
	Asia fixed income			We are neutral on Asia fixed income. The pandemic's containment in many countries and low energy exposure are positives. Renewed U.S.-China tensions and China's relatively muted policy fallout are risks.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. 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.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee