Weekly commentary

BlackRock

Nov. 23, 2020

Upgrading U.S. equities

- We upgrade U.S. equities to overweight, expecting this market to benefit from both structural growth trends and a potential cyclical upswing during 2021.
- Surging Covid cases and new restrictions in the U.S. have weighed on markets even as positive vaccine news points to an accelerated restart during 2021.
- This week's purchasing managers' index data could help gauge the impact from lockdowns in the euro area and UK, and show signs of softening U.S. activity.

We upgrade U.S. equities to overweight, with a preference for quality large caps riding structural growth trends – as well as smaller companies geared to a potential cyclical upswing. We prefer to look through any near-term market volatility as Covid cases surge. Positive vaccine news reinforces our outlook for an accelerated restart during 2021, reducing risks of permanent economic scarring.

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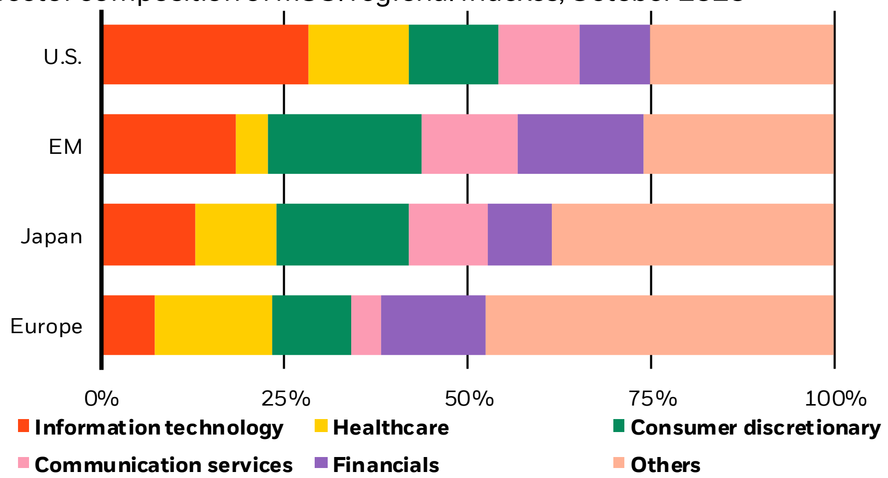
Chart of the week

Sector composition of MSCI regional indexes, October 2020



Sources: BlackRock Investment Institute, with data from MSCI as of Oct. 30, 2020. Notes: Information technology, healthcare, consumer discretionary, communication services and financials are top five sectors on the MSCI ACWI Index by weight. Others include industrials, consumer staples, utilities, real estate, materials and energy.

The pandemic has accelerated some key structural trends, such as increased flows into sustainable assets and the dominance of big tech companies. The U.S. market has a favorable sector composition compared with other major equity markets. It boasts a higher share of quality companies – those with strong balance sheets and free cash flow generation – in sectors backed by long-term growth trends such as tech and healthcare. Information technology and communication services represent nearly 40% of the market value of the MSCI USA Index, compared with just 11% in Europe. See the chart above. The U.S. tech sector is about more than just the handful of mega caps that have led market performance in recent years and face heightened regulatory scrutiny. Semiconductor and software companies, for example, face few regulatory risks and enjoy long-term growth trends. The financial sector – under pressure from the low interest rate environment globally – represents a relatively small slice of the U.S. market in comparison to Europe.

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Markets have been weighing a near-term resurgence in Covid cases against advancing vaccine development. We expect rising infections and new restrictions to cause activity contraction in Europe in the fourth quarter, with the U.S. close behind. Meanwhile China is set to return to its pre-Covid growth trend thanks to better virus control, boding well for the rest of Asia and emerging markets (EMs). The challenging months ahead in the U.S. and Europe could support the case for further outperformance of large-cap tech and healthcare companies. At the same time, prospects for an accelerated economic restart during 2021 could favor more cyclical exposures. Should investors stick to quality – a perennial recent winner – or rotate into beaten down cyclical exposures?

We believe this is not an "either/or" question – and advocate a more nuanced approach. A "barbell" strategy that includes allocations on one side to quality companies benefiting from structural growth trends; and on the other to selected cyclical exposures. This can help achieve greater portfolio resilience amid still high levels of uncertainty about vaccine deployment and the prospects for further pandemic relief, we believe. Our tactical upgrade to U.S. equities and long-held preference for the quality factor are how we choose to gain exposure to structural growth. We take a selective approach to cyclical exposures, with overweights in EM equities; Asia ex-Japan equities and the U.S. size factor, which tilts toward mid- and small-cap companies. EMs should benefit from a global cyclical upswing in 2021 as well as more predictable U.S. trade policies under President-elect Joe Biden. The size factor is geared to a U.S. cyclical upswing.

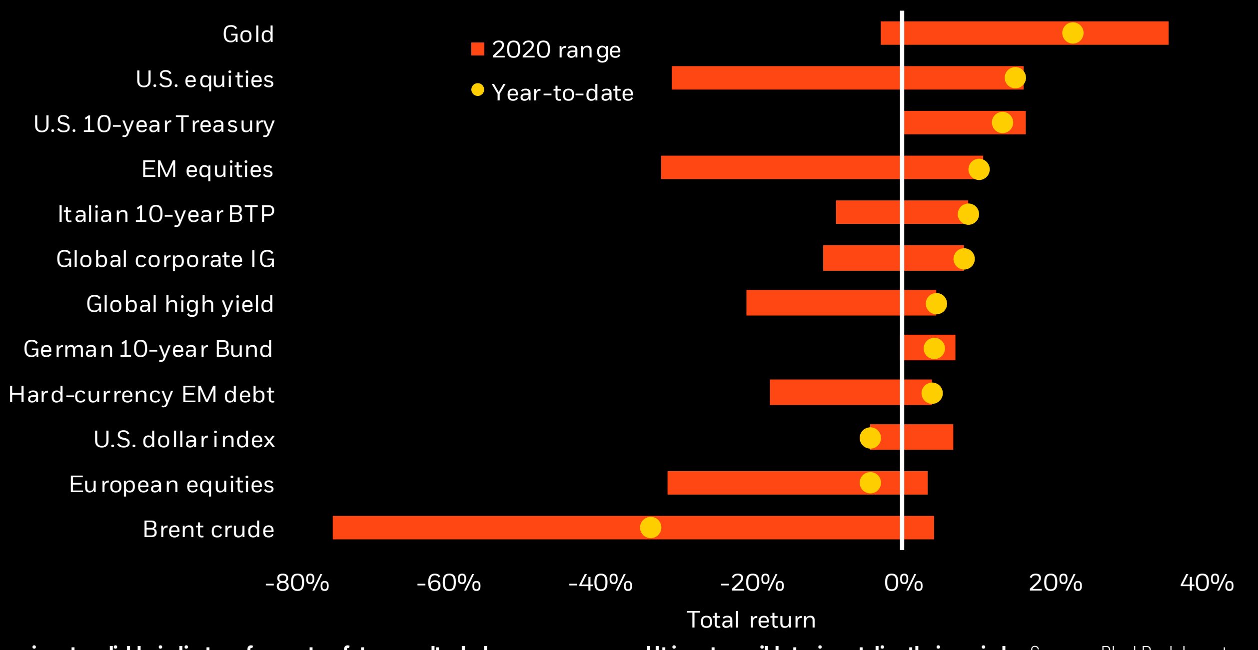
We prefer avoiding more structurally challenged cyclical exposures. We have downgraded European equities to underweight and hold an underweight in Japanese equities. The European market has a relatively high exposure to financials, which we see pressured by low rates. Japan may not benefit as much as other Asian countries from a cyclical upswing, and could see its currency driven up by a weaker dollar – a result of monetary easing and more stable trade policy under a Biden administration. Bottom line: We see the vaccine development providing a constructive backdrop for risk assets as we approach 2021, but advocate a balanced approach: quality companies that should outperform even if fiscal support disappoints; and selected cyclical exposures that are likely to thrive as the timeline for widespread vaccine deployment advances. A key risk to our U.S. equities view: The winding down of key Fed/Treasury emergency support facilities by the U.S. Treasury highlights risks ahead for overall U.S. policy support, especially on additional fiscal relief.

Market backdrop

Markets have been weighing the near-term Covid resurgence against positive news on long-term vaccine development. Effective vaccines would allow a broader opening-up of activity sooner and reduce the risk of long-term scarring. This reinforces our view that the cumulative economic hit from the Covid shock will be just a fraction of that seen in the wake of the global financial crisis. Yet we do see potential for near-term disruption to the economic restart caused by the ongoing virus resurgence and government restrictions.

Assets in review

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



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2020. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current 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 gold, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

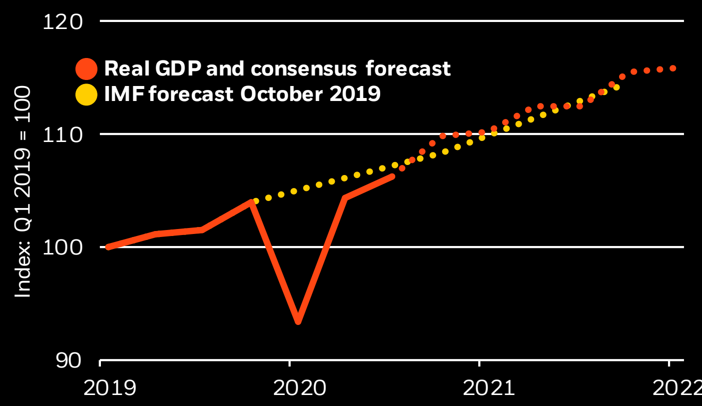
Macro insights

China is still leading the restart in global activity. Better management of Covid outbreaks means that activity should return to the pre-Covid trend far ahead of both developed and emerging market peers. Strength in exports and domestic consumption means China's growth is likely to be above the global average this year and next. And stronger growth in China - the only major economy expected to grow positively on average in 2020 - is important in the context of an increasingly bipolar world, with the U.S. and China set to be the dual engines of growth.

Consensus expectation is for the level of activity in China to return to the pre-Covid *trend* by the end of 2020. See the chart. This contrasts sharply with the U.S. and euro area, where the consensus sees activity returning to pre-Covid *levels* by the end of next year – although the positive news around vaccines could change this. China's comprehensive fiscal and monetary policy support has now started to moderate, and this means the risk of financial vulnerabilities caused by Covid should be contained.

Back on track

Real Chinese growth and growth forecasts, 2019-2022



Sources: BlackRock Investment Institute and the IMF, with data from Haver Analytics, Nov. 2020. Note: The solid orange line shows the path of real GDP in China, indexed to 100 in Q1 2019. The dotted orange line shows the implied level of GDP based on Bloomberg consensus forecasts of year-on-year growth rates at a quarterly frequency. The yellow dotted line shows the path of real GDP under the IMF's October 2019 World Economic Outlook forecast. There is no guarantee any forecasts made will come to pass.

Investment themes

1 Activity restart

- Positive Covid vaccine developments reinforce our expectation that the economic restart can gather steam again in 2021, even as the virus resurgence and renewed tighter restrictions look set to disrupt activity in the near term.
- The sharp rise in Covid hospitalization rates in Europe has led to the re-imposition of national lockdowns – albeit not as stringent as in the spring. New fatalities in Europe are on the rise, albeit growing more slowly since the lockdowns. Many U.S. states are tightening or imposing restrictions as Covid cases and hospitalizations have risen rapidly.
- 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 if mobility is curtailed for an extended period of time.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both strategic and tactical horizons. We are tactically overweight broad EM, Asia ex-Japan equities and the size style factor in the U.S., and have downgraded European equities to underweight.

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. Policy support – both fiscal and monetary – is still a crucial bridge before the rollout of effective vaccines.
- Risks of policy fatigue are rising. The U.S. Treasury's decision to end several emergency lending programs at year-end highlighted the risk of fading fiscal support, even though for now the action may pose only limited risks to financial stability and credit availability, and the Fed could extend lending facilities if needed. A Biden administration could be constrained in implementing its key policy plans including large fiscal spending. The European Central Bank has committed to take new action in its December policy meeting.
- 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 it's 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 target levels. Combined with structural changes accelerated by Covid, it could lead to higher inflation in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on both strategic and tactical horizons. We are overweight high yield on a tactical basis.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We see countries, sectors and companies making a comeback as potential diversifiers in a fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. We believe investors should consider alternative return sources that can provide potential diversification.
- A focus on sustainability makes portfolios more resilient, in our view. We believe the adoption of sustainable investing is a tectonic shift carrying 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 on a strategic basis. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops.

Week ahead

Nov. 23	Flash composite purchasing managers' index (PMI) for the euro area, UK and U.S.
Nov. 24	Ifo Business Climate Index; U.S. consumer confidence
Nov. 26	Japan consumer price index

This week's flash PMI data for the U.S. and Europe will be in focus. Markets will look for signs of how much Europe's renewed lockdowns have weighed on growth, and for any softness in U.S. data against the backdrop of surging Covid cases. U.S. consumer confidence data could shed light on the health of consumer spending, the biggest component of the U.S. GDP, after retail sales in October appeared to have lost steam.

Directional views

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

Asset	Strategic view	Tactical view	
Equities	Neutral	Neutral	We are 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 EM especially Asia ex-Japan stocks.
Credit	Neutral	+1	We are 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, in our view, 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, November 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, November 2020

	Asset	Underweight	Overweight	
Equities	United States			We upgrade U.S. equities to overweight. We see quality companies in sectors such as technology offering exposure to ongoing structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
Equities	Euro area			We downgrade European equities to underweight. Renewed restrictions look set to weigh on activity over coming months. We also view European equities as structurally challenged in a post-Covid world.
Equities	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration.
Equities	Emerging markets			We are overweight broad EM equities as more stable foreign and trade policy under a Biden administration could benefit EM assets.
Equities	Asia ex-Japan			We are overweight Asia ex-Japan equities. China and a number of other Asian countries have done a better job of containing the virus – and are further ahead on the road to economic recovery.
Equities	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.
Equities	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.
Equities	Minimum volatility			We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
Equities	Quality			We are overweight quality. We see it as resilient against a range of outcomes in the pandemic and economy.
Equities	Size			We are overweight size. We expect small- and mid-cap U.S. companies to likely benefit from a cyclical upswing over the next 6-12 months with positive Covid vaccine development, even as the outlook for large fiscal stimulus dims.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. An accelerated economic restart in 2021 could spur higher yields and a steeper yield curve.
Fixed Income	Treasury Inflation-Protected Securities			We upgrade TIPS to overweight. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy, greater fiscal stimulus and increasing production costs.
Fixed Income	German bunds			We upgrade bunds to neutral. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
Fixed Income	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.
Fixed Income	Global investment grade			We hold investment grade credit at neutral. We see little room for further yield spread compression. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
Fixed Income	Global high yield			We keep our strong 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.
Fixed Income	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.
Fixed Income	Emerging market – local currency			We are still underweight local-currency EM debt. 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.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. China and other Asian countries have done better in containing the virus and are further ahead on economic recovery.

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