

# Weekly commentary

May 4, 2020



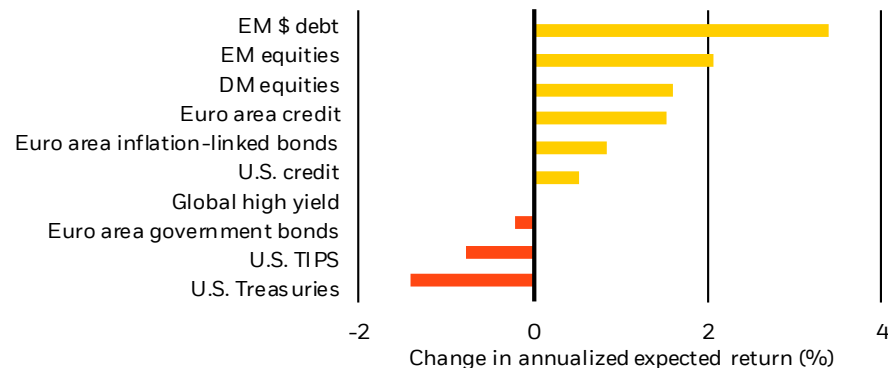
## Strategic asset views amid virus shock

- We favor lowering long-term allocations to nominal government bonds and increasing those to risk assets in the wake of the pandemic.
- Global equities closed out April with their biggest monthly gain since 2011 amid talk of cautiously re-opening economies.
- This week’s senior loan officers survey by the Federal Reserve is an important indicator of financial stress.

The coronavirus shock has triggered market turbulence over the last three months. Does this represent a need and opportunity for long-term investors to adjust their strategic allocations? We think so – based on price dislocations alone and when considering potential changes in medium-term fundamentals. Our main conclusion: We favor cutting nominal government bond allocations and allocating more to risk assets.

## Chart of the week

Estimated change in five-year expected returns from 2020 price moves



Forward looking estimates may not come to pass. Indexes do not include fees. It is not possible to invest directly in an index. Source: BlackRock Investment Institute, as of April 13, 2020. Notes: The bars show how our expected five-year returns (in U.S. dollar terms) for selected asset classes might change relative to our latest ones (as of Dec 31, 2019) assuming year-to-date asset price performance only. The indexes are JPMorgan GBI-EM Index, MSCI Emerging Markets Index, MSCI World index, ICE BofA Merrill Lynch 10+ Year Euro Corporate Index, ICE BofA ML EMU Direct Government Inflation Linked Index, Bloomberg Barclays U.S. Credit Index, ICE BofA Merrill Lynch Global High Yield Index, Bloomberg Barclays Euro Aggregate Treasury Index, Bloomberg Barclays US Government Inflation-Linked Bond Index and Bloomberg Barclays U.S. Treasury Index.

All else equal, a selloff in a given asset class makes it more attractive through a valuation lens, mechanically increasing our expected returns in the coming five years. Even after the substantial rebound in recent weeks across risk assets, their price declines this year still imply a hefty boost to our expected returns. Conversely, the rally in government bonds points to lower future returns compared with our expectation at the start of the year. The chart above estimates the change in our expected returns based on recent price moves alone, ahead of the release of our full set of long-term return expectations later this month where we will take into account more than pure price action. Also not shown in the chart above: potential changes to fundamentals in the years ahead, such as the impact of the economic shock and policy action on corporate earnings, interest rates and medium-term inflation expectations.



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The pandemic has triggered an abrupt, deliberate stop to economic activity. What matters to long-term asset prices is the cumulative impact of the growth shortfall over time. We believe that the policy actions to cushion the impact of the virus shock should help limit permanent damage to growth fundamentals. Given successful policy execution throughout the shock, the cumulative impact would be well below that seen after the 2008 global financial crisis. We are assessing other potential structural changes the outbreak might bring on in the years ahead – and the implications on asset classes. Think of the reorganization of global supply chains that had started before the pandemic amid heightened trade tensions, with their potential impact on corporate profits and inflation.

A key strategic view has emerged from market reaction and policy response to the pandemic: a materially diminished case for nominal developed market government bonds. Falling yields have lowered their expected returns and reduced their ballast properties, particularly for liability-agnostic investors. If bond yields are near effective lower bounds, their ability to act as portfolio ballasts during risk-off events is less than in the past. This was evident when lower-yielding euro area and Japanese bonds provided less ballast than U.S. Treasuries in the recent equity selloff. Inflation-linked bonds may be a more preferable risk-off asset over a strategic horizon if supply chain changes pick up pace, monetary policy is more accommodative over the long term and inflation risk rises – even as this year’s rally has mechanically eroded their long-term return expectations, as the chart shows.

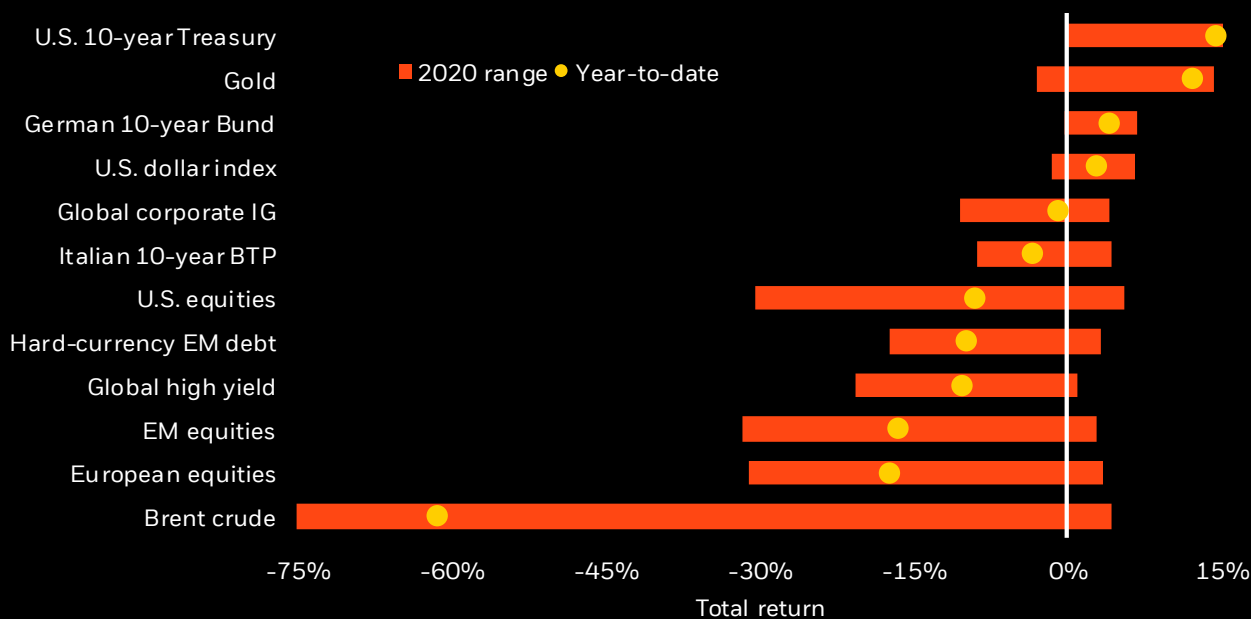
We see a strategic opportunity to allocate more to risk assets. Many portfolios have drifted from their target asset allocation. We prefer rebalancing equity exposure back up to target, though the ongoing policy response has helped equities stage a sizable rebound. Equities remain a key source of return in strategic portfolios even when considering changing fundamentals such as earnings declines, in our view. We also see a strong – yet more nuanced – strategic case for credit. Valuations have cheapened, more than equities on a risk-adjusted basis. Yet risks such as higher defaults, particularly in the high yield market, cannot be ignored. Over the next six to 12 months, we favor credit over equities given bondholders’ preferential claim on corporate cash flows and prefer an up-in-quality stance in equities. We are neutral on government bonds on a tactical basis, as we see risks of a diminishing ballast and a snap-back in yields from historically low levels.

## Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the key is policy execution to ensure households and businesses get the cash being promised. The MSCI ACWI had its best monthly performance in April since October 2011, after three months of decline. The S&P 500 Index had its best month since 1987 with a 13% gain. Oil prices retraced part of recent losses last week, and the technology-heavy Nasdaq index almost turned positive for the year.

## Assets in review

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



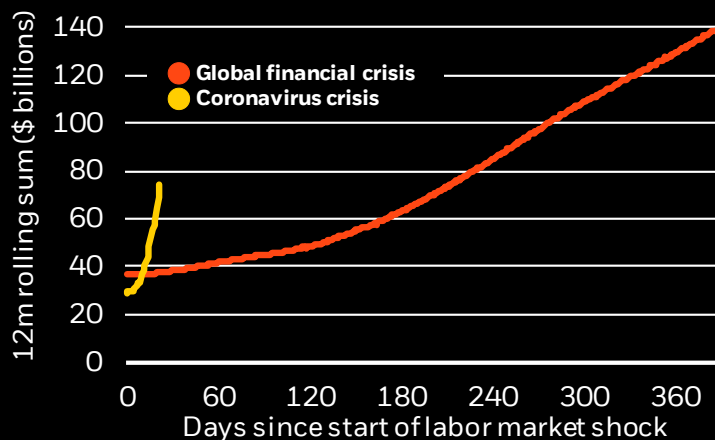
**Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end 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

The coronavirus shock has triggered an abrupt stop to economic activity, leading to a colossal loss of income. Some fiscal support has started to flow, as execution of the comprehensive policy response has come into sharp focus. Alongside the historic spike in initial jobless claims, the unemployment insurance (UI) pay-out in the U.S. has increased by nearly \$50 billion since the end of March, eclipsing the pace of increase in UI payments over the same number of days since the global finance crisis hit the labor market. Policy initiatives such as Paycheck Protection Program loans, payments to U.S. individuals, and support for local and state governments via the coronavirus relief fund have already paid out a significant share of their total allocations. Senate Democrats are talking about another \$500 billion in aid focused on states and municipalities. Many U.S. citizens are still struggling to apply for unemployment insurance and other benefits. In 2018 nearly 40% of households said they would be unable to cover a \$400 emergency expense with cash on hand.

## Social support

U.S. daily unemployment insurance payments to individuals



Sources: BlackRock Investment Institute and the U.S. Treasury, with data from Haver Analytics, April 2020. Notes: This chart shows the 12 month rolling sum of U.S. daily unemployment payments to individuals after the labor market shocks that resulted from the global financial crisis (beginning July 1, 2008) and the current coronavirus crisis (beginning March 30, 2020).

## 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 rebound will depend on the path of the outbreak, effective delivery of policy response and potential changes to consumer and corporate behaviors.
- 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

- We believe the required policy response includes drastic public health measures to stem the outbreak. A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets is taking shape, particularly in the U.S. The key: policies to forestall any cash flow crunches among small businesses and households that could lead to financial stresses and tip the economy into a crisis.
- 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. U.S. lawmakers have passed \$3 trillion worth of fiscal stimulus to cushion the blow.
- The European Central Bank stepped up its pandemic response with a new series of pandemic emergency longer-term loans aiming to support liquidity in the euro area financial system. European Union leaders agreed on the need for an emergency fund of at least 1 trillion euros, but stopped short of agreeing on how it will be financed and tasked the European Commission to sort out details.
- Some actions are raising questions about whether they may undermine the independence of central banks. The UK Treasury activated a funding facility for spending that will be directly financed by the Bank of England, rather than the gilt market, but called the move temporary.
- It’s crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central bank policy has moved from mostly alleviating the dysfunction of market pricing and tightening of financial conditions to ensuring credit flows to businesses and local governments.
- 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

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds. The recent bounce in Treasury yields off record lows illustrates the risk of snapbacks.
- 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.
- Market implication:** We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

## Week ahead

<b>May 4</b>	Federal Reserve senior loan officer opinion survey; manufacturing PMI for eurozone	<b>May 7</b>	China Caixin services PMI and preliminary trade data; Bank of England rate decision
<b>May 6</b>	German industrial orders; composite PMI for eurozone	<b>May 8</b>	U.S. nonfarm payrolls

This week’s senior loan officers survey by the Fed will be a focus as it is an important indicator for assessing financial stress. Investors need to keep an eye on any cracks that start to emerge in the financial system and elsewhere in the economy, in our view. As economic activity has already ground to a near-halt, gauging the duration of the activity standstill is becoming more pressing than assessing the depth of the initial shock.

## Directional views











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

Asset	Underweight	Neutral	Overweight
<b>Equities</b>	<p>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.</p>		
<b>Credit</b>	<p>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.</p>		
<b>Government bonds</b>	<p>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.</p>		
<b>Cash</b>	<p>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.</p>		

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.
			Euro area	We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
			Japan	We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
			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.
			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.
			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.
			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.
			Minimum volatility	We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
			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.
			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.
			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.
			Euro area peripherals	We like euro area peripheral government bonds. Renewed asset purchases by the European Central Bank are a major support, and valuations have cheapened.
			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.
			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.
			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.
			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.
			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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