Weekly commentary

BlackRock

June 8, 2020

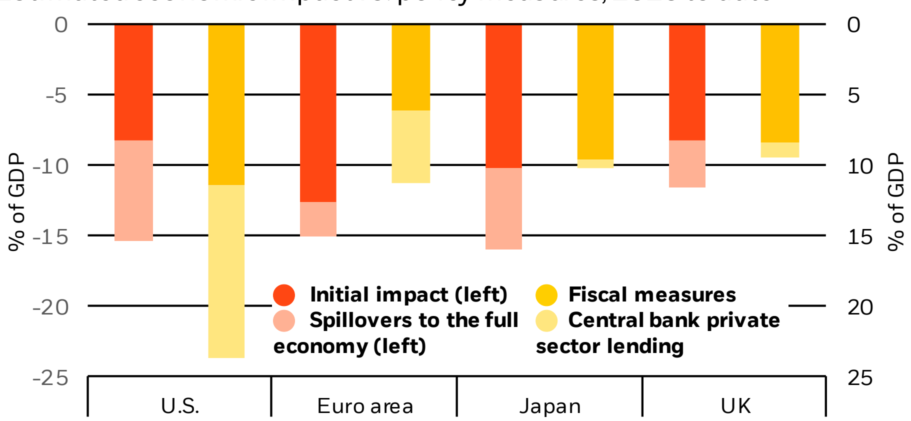
Policy revolution: What's next?

- Macroeconomic policy has undergone a necessary revolution in just three months, but this is a slippery slope without proper guardrails.
- The key to the policy response has shifted to ensuring successful execution and avoiding policy fatigue before the shock passes.
- This week's Federal Reserve policy meeting will be in focus as markets watch for the Fed's take on the economic rebound.

Macroeconomic policy has gone through a needed revolution to cushion the coronavirus shock. It essentially aims to "go direct" and is blurring fiscal and monetary policies. Yet this policy shift has opened the door to unprecedented government intervention in markets and companies, and we see it as a slippery slope - unless it comes with proper guardrails and a clear exit strategy.

Chart of the week

Estimated economic impact vs. policy measures, 2020 to date



Sources: BlackRock Investment Institute, with data from the Federal Reserve, European Central Bank, Bank of Japan, Bank of England, and Haver Analytics, June 2020. Notes: We use estimated targets for the total size of the U.S. and euro area corporate purchases and lending schemes for 2020. For the euro area we include TLTRO funding, and for the UK we include central bank support for the TFS bank lending scheme. The euro area numbers are averages of the four largest economies in the bloc, Germany, France, Italy and Spain.

The scale and speed of the policy response has been greater than at any moment in peacetime history, fundamentally transforming the core tenets of global policy frameworks and financial markets. We view the economic impact and policy response as two key signposts for gauging the virus shock, and compare our assessment of the lost national income across major economies with policy measures announced to date. The orange bars show the full-year hit to GDP from our sector-level bottom-up analysis, including the initial impact on the most affected sectors (such as travel and leisure) and the broader impact on the whole economy due to spillover effects (light orange). The fiscal response more than covers the initial impact in the U.S. Once we factor in the spillover to the full economy, the fiscal policy response (dark yellow) globally falls short. Yet the situation improves when monetary policies (light yellow) are accounted for. This is especially striking in the U.S., as the chart shows.

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Major economies may still struggle to entirely bridge the gap left by the plunge in demand, income and cash flow, despite the unprecedented policy measures, in our view. We see a risk of policy fatigue leading to an exit or a retrenchment too soon, especially in the U.S. The U.S. labor market unexpectedly improved in May, showing signs that policy interventions were cushioning the blow from the shock – and highlighting the risk that policymakers may give up on relief measures sooner than necessary.

The uncharted territory that policymakers have entered makes policy execution particularly important. The new policies explicitly attempt to "go direct" – bypassing financial sector transmission and delivering liquidity to individuals and businesses. Another aspect of this policy revolution is the explicit blurring of fiscal and monetary policies, including central banks absorbing new government debt to maintain low bond yields. In addition, some government support comes with strings attached, including conditions around dividend payouts and share buybacks.

We wrote about the necessity for monetary and fiscal coordination to deal with the next downturn last August. Effective coordination would reduce lost output in a major shock, and could lessen other risks, such as rising inequality, that were seen as arising from the unbalanced policy response to the financial crisis. We warned it needed proper guardrails and a clear exit strategy to mitigate a risk of uncontrolled deficit spending with commensurate monetary expansion and, ultimately, inflation. One approach we laid out is a Standing Emergency Financing Facility (SEFF), a framework in which the exit from the joint monetary-fiscal policy effort is explicitly determined by the inflation outlook. To be credible, this exit decision must be independently controlled by the central bank. And even a well-designed monetary strategy may not prevent a change toward a higher inflation regime in the medium term because of deglobalization and re-regulation trends.

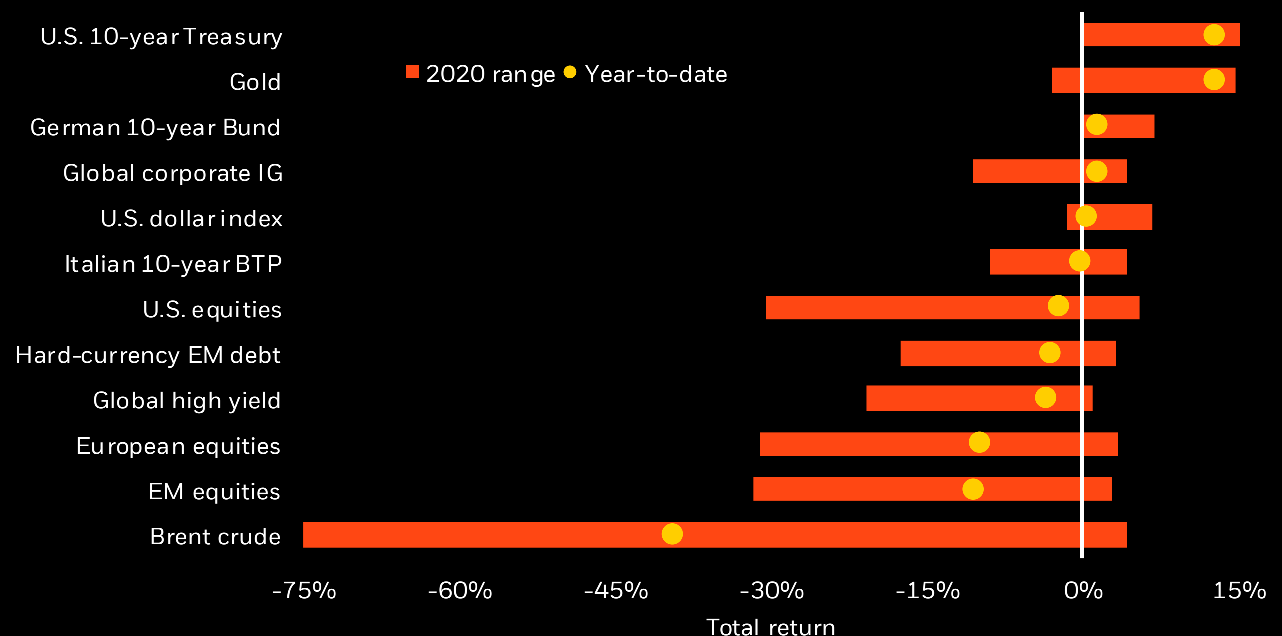
The bottom line: The policy revolution is a near-term positive for markets but, in the absence of guardrails, might not be in the medium term. One key investment implication is the reduced ballast properties of nominal government bonds over a strategic horizon, as interest rates are near or at their effective lower bounds and we see greater inflation risks in coming years. We think increased strategic allocations to inflation-linked bonds are sensible amid this shifting balance of risk.

Market backdrop

Measures to contain the virus are gradually being eased in many developed economies. May's data suggested the worst of the contraction may be behind us, but we see a bumpy restart in coming months. The big question remains: how successful policy execution will be in bridging cash flow constraints and preventing permanent damages to the economy – and what the risk is of policy fatigue in coming months. Markets became wary of rising U.S. China tensions.

Assets in review

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



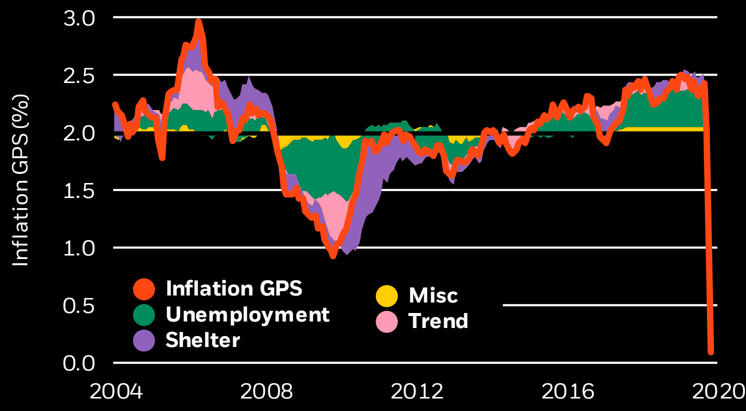
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, June 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 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 pandemic has spurred both a steep decline in demand and huge pressures on supply. This unusual combination has implications for the path of inflation: the former pulls inflation down, but the latter pulls it up. Our view? In the short run, weak demand is likely to win this tug of war, helped along the way by the fall in oil prices. Yet inflationary pressure could build up more quickly than expected due to curtailed capacity in personal services, profound shifts in monetary policy and secular trends such as deglobalization. Our Inflation GPS illustrates the disinflationary potential of the coronavirus pandemic in the short term, with both the U.S. and euro area indicators falling sharply. The sudden increase in labor market slack – as workers have become unemployed or been moved to short-time work programs – has been a driver. For the U.S., we find that the sharp rise in the unemployment rate has been the most important factor, while in the euro area it has been broader underemployment given the prevalence of short-time work programs.

Eyes on the price

BlackRock U.S. CPI Inflation GPS and breakdown, 2004-2020



Sources: BlackRock Investment Institute, with data from Haver Analytics, June 2020. Notes: The inflation GPS shows where core (excluding food and energy) consumer price inflation (CPI) may stand in six months' time. The chart shows the breakdown of the GPS components. Individual contributions are shown as deviations from their sample means. Unemployment is the headline unemployment rate. Shelter is a consumer price measure of rent costs. Trend is the underlying, slowly evolving inflation trend. Miscellaneous is the average impact of effects not controlled by our model. Forward-looking estimates may not come to pass.

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 and stringent shutdown measures are gradually being lifted.
- 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 sticking to benchmark holdings in most asset classes and prefer credit over equities.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets has taken 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 shock and ensuring markets function properly. We could see its balance sheet more than double to nearly $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.
- Europe's response has been slower than elsewhere but starts to stand out when the risk of policy fatigue in the U.S. is increasing. Germany announced a bigger-than-expected €130 billion fiscal package. The ECB expanded its pandemic emergency purchase program more than anticipated. France is due to present its package next week.
- China moved away from setting a GDP growth target for 2020, emphasizing *quality* of growth over *quantity*, and announced fiscal stimulus of around 4% of GDP.
- A German constitutional court ruling threatens the European Central Bank's independence and could lead to euro area fragmentation in the long run. It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments.
- 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.

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 sustainable investing.

Week ahead

June 10	China consumer price index and producer price index; Federal Reserve policy meeting
June 12	University of Michigan Survey of Consumers June preliminary

The Fed's policy meeting and the preliminary release of the University of Michigan Sentiment for June will be the focus this week. The Fed is expected to reiterate the whatever-it-takes approach, and keep its interest rate guidance unchanged. Its Summary of Economic Projections is likely to describe a slow economic rebound. The University of Michigan survey will show where consumer sentiment stood after U.S. consumers cut spending by the most on record for two straight months.

Directional views

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

Asset	Underweight	Neutral	Overweight
Equities		■	
Credit			■
Government bonds		■	
Cash		■	

Equities

We are neutral on global equities. 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.

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, June 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 holding our overweight in euro area peripheral government bonds. Fiscal authorities increased stimulus and the European Central Bank expanded its asset purchases program to cushion the pandemic's impact.
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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