Weekly commentary

BlackRock

June 15, 2020

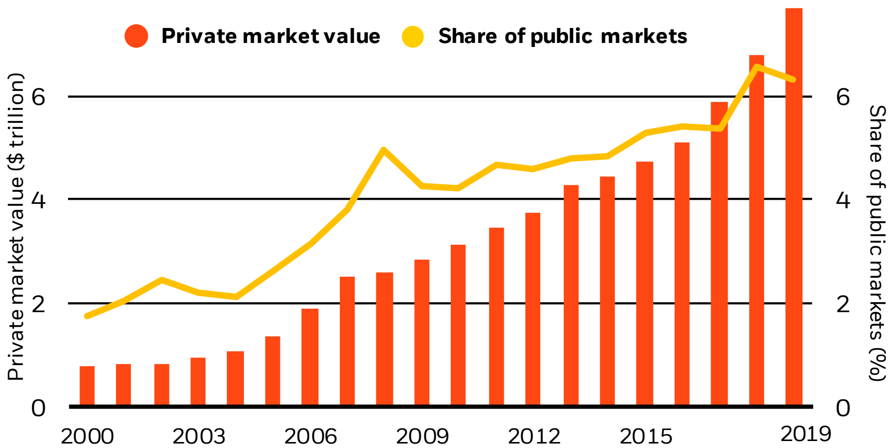
Private markets as diversifiers

- We see diversification with - and within - private markets as crucial to building resilient portfolios in a low-rate, post Covid-19 world.
- The key to the policy response has shifted to ensuring successful execution and avoiding policy fatigue before the shock passes.
- The Bank of England is expected to keep interest rates unchanged and expand its government bond purchase program.

Public markets were at the center of market action as risk assets sold off amid the spreading pandemic and then rebounded amid an overwhelming policy response. We now see opportunities in slower-moving, less liquid private markets and expect them to offer exposure to accelerating structural trends. Diversification with - and within - private markets will be crucial to building resilient portfolios, in our view.

Chart of the week

Growth in private markets, 2000 -2019



Sources: BlackRock Investment Institute, with data from Preqin, June 2020. Notes: The bars represent the sum of net asset value of closed-end funds as well as dry powder of funds in these asset classes: private equity and venture capital, real estate, private debt, infrastructure and natural resources. The line shows the size of private markets relative to that of public markets.

Private markets are bigger, deeper and a larger component of institutional portfolios than ever before. The private market universe has tripled since the financial crisis to $7.7 trillion today, from $2.5 trillion in December 2007, as the bars in the chart above show. They now make up 6.3% of public market size, from 3.8% then (the yellow line). Allocations to private assets such as private equity (PE), private debt, real estate and infrastructure now make up around 26% of global pension fund assets, up from 19% in 2008, according to consultancy Willis Towers Watson. These markets can be illiquid and are not suitable for all investors. Yet we believe they can help investors build diversified portfolios that are more representative of the global economy than public markets alone. Our work also suggests many institutional investors are more worried than they need to be about liquidity constraints, and that owning more private assets could help them meet return and diversification goals.

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Why consider private markets now? Risk assets in public markets have rapidly rebounded after hitting lows in late March as uncertainty about the virus impact peaked, removing some of the value there on a tactical basis. Even after last week's selloff, the S&P 500 index is up almost 40% from lows. The policy revolution has cushioned the pandemic's fallout, and economies are slowly reopening, making this a time to unlock value in slower-moving private markets. Moreover, we expect wide variations in activity normalization, by region and sector and company. This calls for a greater focus on *real* resilience at a granular level. We believe private markets offer this potential. Investors have a say in structuring the investments and can add custom-made resilience—via contractual provisions, avoidance of excess leverage and choice of counterparty.

Private managers at first primarily played defense in the virus shock—a rapid reassessment of the operating and liquidity needs of the assets they already owned. This is morphing into offense: seizing opportunities in the market dislocations. What is tomorrow's opportunity set? The first is providing liquidity, rescue and turnaround finance. Quality companies that have lost bank financing may need liquidity bridges while their operations recover. The shock is likely to produce a large market in distressed debt. There are at least $600 billion of distressed assets trading today, and we expect this to increase.

The second is seizing opportunities in sectors benefiting from accelerating structural trends. The pandemic is irrevocably reshaping the economy and investment landscape, and investors focused on public markets alone may miss out on opportunities in sustainability, digitalization and public health. Examples are renewable power (the most active infrastructure sector in 2019, according to IJGlobal); and technology and health care (which accounted for 19% and 13%, respectively, of private equity (PE) deals in 2019, according to Preqin).

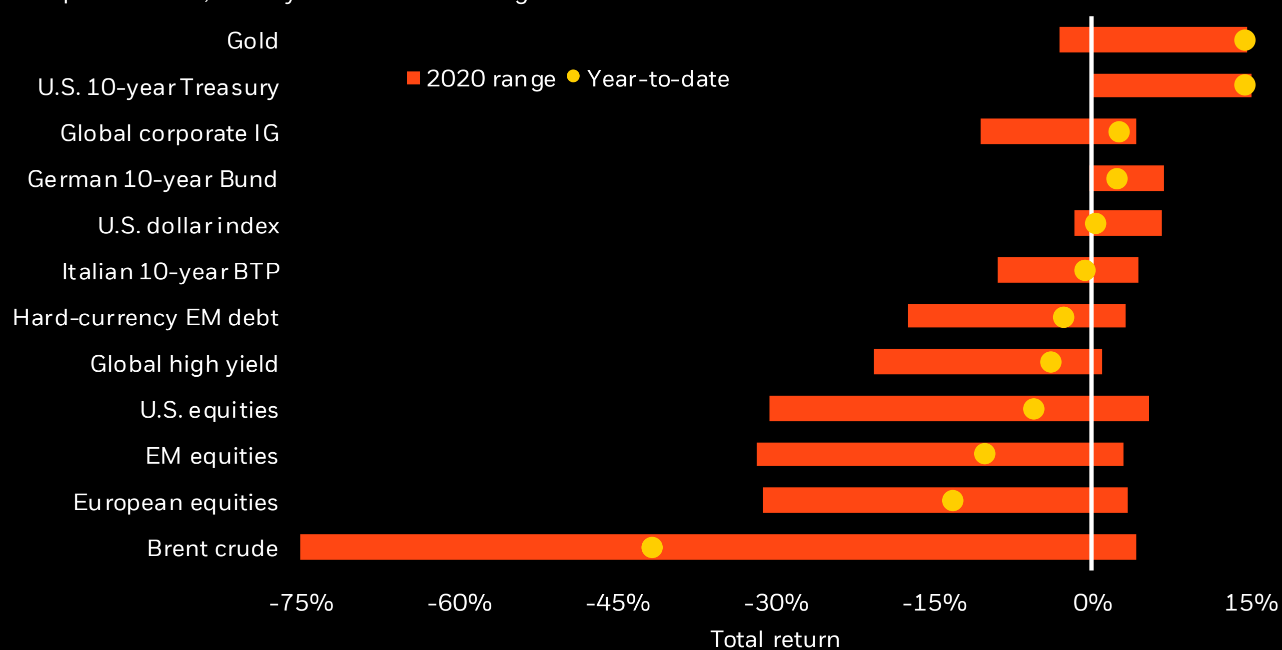
The virus shock is unlike anything else, but the global financial crisis does hold some lessons for private market investors. First, vintages (when a private market fund deploys its capital) after a crisis tend to be good ones. Second, opportunities in different sectors come and go on different timelines—credit more quickly, for example, and real estate more slowly. Third, the difficulty of timing markets (and especially private markets) makes diversification of vintage years crucial. Bottom line: We believe private markets will play an increasingly important role in fortifying strategic portfolios.

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. We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen. The unprecedented policy response has boosted markets, leaving a potential second wave of infections and policy implementation as key risks. U.S. Congress is headed for a fiscal cliff as jobless benefits, state support and payroll protection measures are expiring soon.

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.

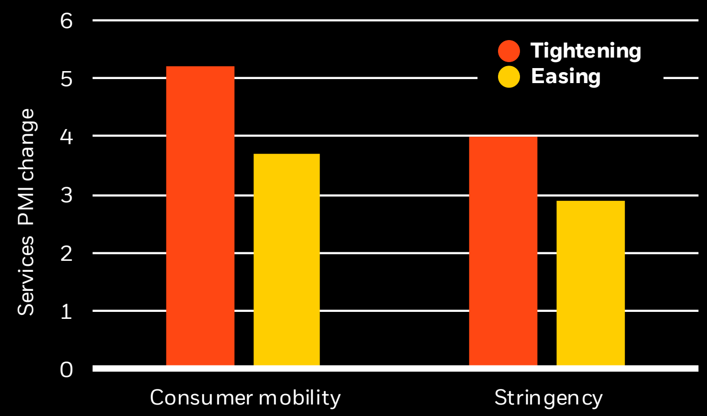
Macro insights

Mobility is starting to recover as governments ease lockdowns. The relationship between lockdown stringency, mobility patterns and Purchasing Managers' Indices (PMIs) suggests that mobility changes (the first set of bars in the chart) have a larger impact on business sentiment than lockdown measures (the second set) do in developed markets. And imposing lockdowns and restricting movement (the red bars in the chart) has a bigger effect than lifting those measures (the yellow bars).

In other words, the relationship between tightening and easing is asymmetric. A 10-point tightening in mobility led to a 5.2 point decline in the services PMI, yet a 10-point easing only recovered 3.7 points. The service sector was hit harder than the manufacturing sector by the sudden stop in activity. The likely reason? Services tend to be more contact-intensive. And manufacturing companies were able to operate even at the height of lockdowns in many countries.

Asymmetrical assessment

Mobility and lockdown impact on service sector activity



Sources: BlackRock Investment Institute, Oxford University and Google with data from Haver Analytics, June 2020. Note: This chart shows the impact that a 10 point move up or down in consumer mobility data and stringency measures have on the service sectors of nine developed market economies. We use Google data on retail and recreation mobility for the mobility score and Oxford data on lockdown stringency. We use a panel regression technique that combines country and time dimensions to measure the marginal effect of mobility on service sector activity, and how this differs between tightening and easing phases.

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 just over $10 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.
- The Fed in its June 10 meeting steered clear of committing to explicit yield curve control.
- We are gaining confidence in Europe's policy response, including expanded asset purchases by the European Central Bank, but a proposed €750 billion joint recovery fund may face implementation challenges.
- 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 15	U.S. Empire State survey
June 16	Bank of Japan interest rate decision; U.S. industrial and retail sales for May; German ZEW economic sentiment
June 18	Bank of England interest rate decision; Philadelphia Fed Manufacturing Survey

The Bank of England is expected to keep interest rates unchanged at its policy meeting this week. Analysts expect it to expand the gilt purchase program while keeping its corporate debt buying unchanged, according to a Reuters poll. The BoE may also mention the negative interest rate debate – but only to the extent of discussing further options should the need arise.

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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