Weekly commentary

BlackRock.

Oct. 19, 2020

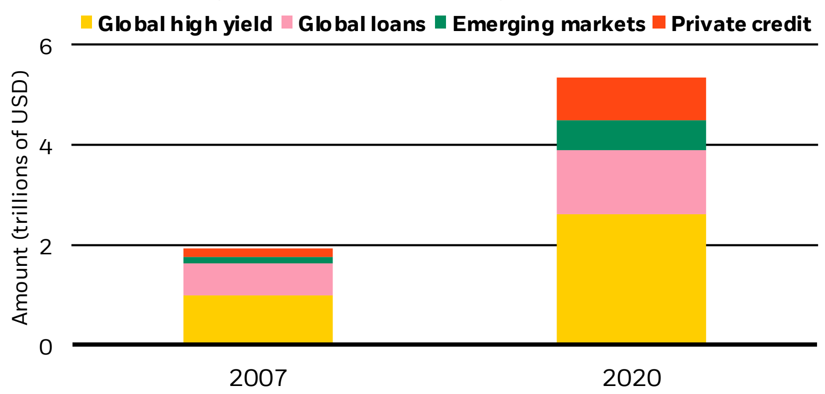
Restructuring opportunities

- We like higher-yielding credit amid low rates, and see corporate restructurings offering growth and potential return diversification for private credit investors.
- A pickup in Covid-19 cases may weigh on mobility and activity in the near term, but we see this wave of infections as much shallower than the spring one.
- A spate of purchasing managers' index data this week could shed light on any potential impact that increased virus infections has had on activity.

Many companies may need to turn to private credit to restructure post-Covid. We see potential for such investments to serve as growth assets and diversifiers when new sources of portfolio resilience are needed. This complements our preference for higher-yielding credit amid low rates. Private markets are relatively illiquid and not suitable for all investors but play a key role in strategic portfolios, in our view.

Chart of the week

Sub-investment grade debt outstanding, 2007 and 2020



Sources: BlackRock Investment Institute, October 2020. Notes: Indexes used are Bloomberg Barclays Global High Yield Index, S&P/LSTA Leveraged Loan Index + S&P European All Loans Index, and JP Morgan CEMBI Index. Private credit data are from Preqin. Index data are as of June 30, 2020, and the private credit data as of Dec. 31, 2019. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

The scale of the restructuring needs could exceed the previous peak seen after the 2008 global financial crisis (GFC). One big reason is the significant growth in sub-investment grade debt since the crisis. The amount of sub-investment grade debt outstanding has more than doubled to $5.3 trillion since 2007, as the chart shows. Private credit has been an especially fast-growing segment, expanding to $850 billion by financing companies that would previously have looked to banks or the public high yield market. As debt markets grew and the overall cost of debt fell, companies became increasingly levered. The average interest coverage ratio – a gauge of solvency - for middle market buyout transactions in 2019 fell to levels that were last seen immediately before the GFC and bursting of the tech bubble in the early 2000s. This left many vulnerable as their revenues come under pressure from Covid-related disruptions. It creates opportunities for restructuring and distressed debt specialists, an important subset of the private credit market. Many institutional investors remain under-invested in the growing private markets, we believe, and may be underappreciating their ability to take on liquidity risk.

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Supportive fiscal and monetary policies to cushion the pandemic's blow have helped companies raise capital and lower borrowing costs. Yet not all borrowers have benefited equally. Large companies have borrowed with ease on the public market; smaller firms have lacked the same access. The interest rate gap between U.S. middle market and large corporate loans has widened this year, according to S&P's Leveraged Commentary & Data (LCD). Many companies will likely have to evolve their business models as the pandemic accelerates long-term structural trends such as digitalization. We see this creating a wave of restructurings – and room for private credit to cater to smaller and lower-credit quality issuers.

The ability to choose a good manager is integral to the case for holding private assets: our previous work has shown the dispersion of realized returns in private asset managers is typically greater than that of public managers. With risks of policy exhaustion and localized lockdowns rising, it becomes even more important to pick private market managers who can assess credit risk and structure resilient investments. Corporate restructurings typically involve complex negotiations between creditors. Success for creditors often means avoiding losses from defaults and restructuring by elevating the seniority of the debt in the capital structure. Buying discounted loans and bonds in the secondary market to seek control was typical after the GFC. These types of transactions will play an ongoing role, yet we see the focus potentially shifting due to a decade of erosion in lender protection. About three-quarters of the U.S. leveraged loans at the end of 2019 were considered "covenant-lite" – with fewer restrictions on the borrower and less protection for the lender – according to Moody's Investors Service. The Covid shock has hit many companies funded by such loans, but the borrower-friendly terms could mean fewer outright defaults and opportunities for private credit investors to step in to provide fresh capital.

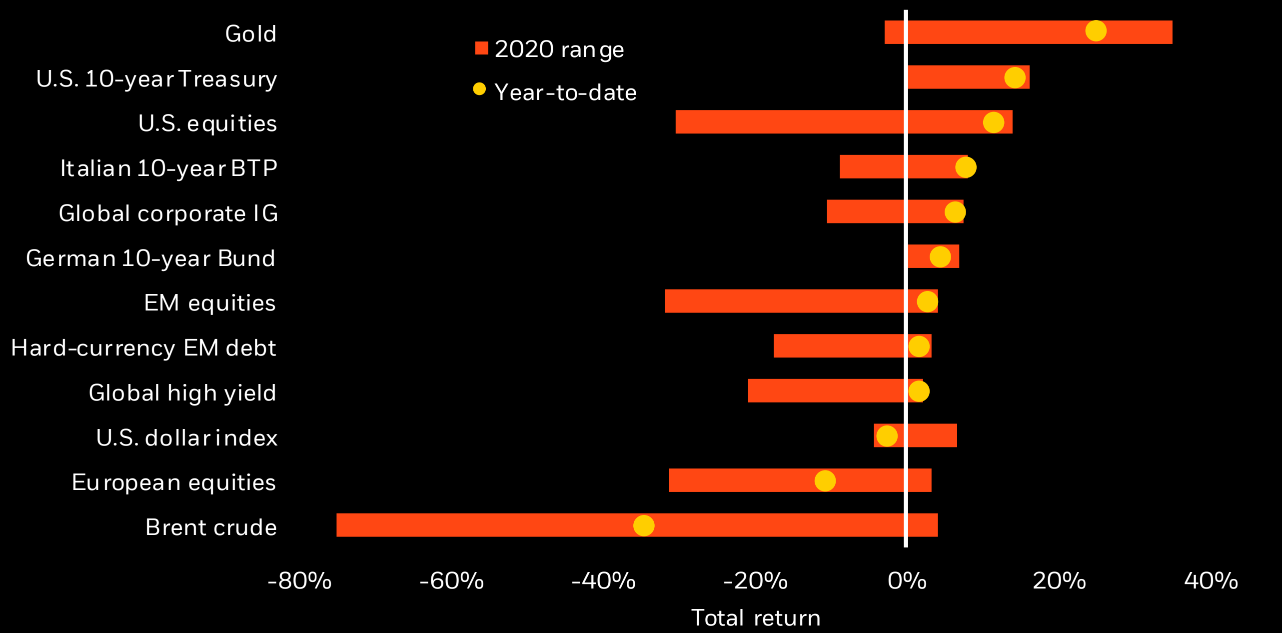
We see a historic opportunity for the private markets to fund post-Covid corporate restructuring. We see a case for a greater share of private market allocations to be in private credit than we typically observe in clients' portfolios. Diversifiers are important at a time when the traditional source of resilience in portfolios – nominal government bonds – may not play the same role. We also favor high yield credit in the public market – on a strategic and tactical basis – for its income potential and adequate compensation for default risks.

Market backdrop

We do not see the resurgence of Covid-19 as a replay of the spring. We believe daily new infections are likely a fraction of the peaks then, and rising case counts are having a diminishing negative impact on mobility. The economic restart has been quicker than expected, but the part that remains will be hardest. We do not expect a similarly large hit to economic activity as seen in the spring. But the economic restart now looks to face significant challenges in the near term. The other market focus: How the U.S. election result could shift U.S. fiscal stimulus, public investment, taxation, regulation and foreign affairs.

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, October 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.

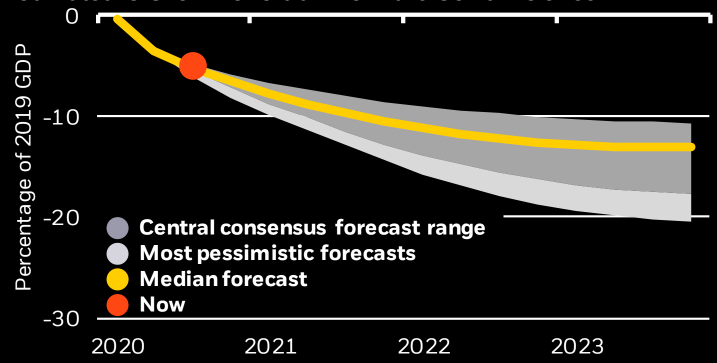
Macro insights

To navigate the Covid-19 shock, we focus on the cumulative losses in economic activity that might build up over time, rather than volatile near-term growth forecasts. The usual business cycle and recession analysis does not apply to this shock. Instead, we see the situation as a natural disaster: A deep and very visible shock that lacks a more damaging propagation mechanism – such as the deleveraging phase that followed the GFC.

The most bearish consensus forecasts estimate the eventual cumulative loss from this crisis in the U.S. at 20% of 2019 GDP. See the chart. This is far smaller than the 50% hit to GDP seen in the decade after the financial crisis. This point was underscored by new International Monetary Fund (IMF) growth forecasts that were more optimistic than its June estimates. Yet we believe the hardest part of the restart is still to come – and renewed virus outbreaks could weigh on the recovery. The IMF also mentioned the risks of long-term scarring to the economy and the struggle that many emerging market economies may face.

Sizing the shock

Estimated U.S. GDP shortfall from the Covid-19 shock



Sources: BlackRock Investment Institute, with data from Reuters News, October 2020. Notes: This chart shows hypothetical total shortfall of U.S. GDP relative to 2019 levels over the next two years based on a Reuters poll of economists. We use the Reuters poll of economists published on Sept. 25, 2020 but trim the sample by taking the estimates within the 20th and 80th percentiles (dark grey shaded band). We derive our range of estimates and median from an adjusted sample of 39 forecasts for which we have complete forecasts. The grey-shaded areas show the full range of estimates, with the most pessimistic estimates showing the lower quintile of forecasts. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass. The hypothetical scenario is subject to signification limitations, in particular that this is an evolving situation and we are still trying to understand the potential for more extensive activity shutdowns due to the virus.

Investment themes

1 Activity restart

- The initial phase of the economic restart has been quicker than expected, as reflected by the IMF's recent upgrade to its global growth outlook. We see the hardest part lying ahead, and the path to a full recovery is likely to be long, uneven and highly uncertain.
- Covid infections have picked up, but fatalities and hospitalizations have risen only moderately. We believe daily new infections are likely a fraction of the peaks, in our view, we see rising case counts having a diminishing negative impact on mobility. All the same, the economic restart looks to face significant challenges in the near term.
- 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.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both a strategic and tactical horizon. 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.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus. Negotiations on a pre-election fiscal package continue in fits and starts, but the window for a pre-election deal is rapidly narrowing. We also see a need for the European Central Bank to step up its relief programs to help cushion the euro area economy.
- 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 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 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, and generally prefer developed markets over the emerging world.

Week ahead

Oct. 19 Japan trade data

Oct. 22 Euro area flash consumer confidence

Oct. 23 Markit flash composite purchasing managers' index (PMI) for the U.S., euro area and UK

A spate of PMI data this week could shed light on the impact of the recent increase in virus infections on the activity restart. Rising case counts are having a diminishing negative impact on mobility, our analysis shows, and policymakers' more localized approach to containment measure poses less of a risk to economic activity. The initial phase of the restart has been quicker than expected, but the hardest part may still be ahead.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 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 Europe among cyclical exposures.
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, October 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, October 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.
Equities	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.
Equities	Japan			We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
Equities	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.
Equities	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.
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 hold min vol at neutral. The restart of economies may benefit cyclical assets and reduce the need for defensive exposures.
Equities	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, we believe, even as low rates reduce their ability to cushion against risk asset selloffs.
Fixed Income	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.
Fixed Income	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.
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, 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.
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 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.

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