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Portfolio perspectives
August 2020

Readying for real resilience

Strategic asset allocation in the post Covid-19 world

BlackRock
Investment
Institute

Summary

- The impact of Covid-19 has transformed the investment landscape in a matter of few months. It is precisely the type of event that underscores the importance of a portfolio construction approach that incorporates uncertainty in estimating asset returns instead of an over-reliance on point estimates. The material changes in our strategic asset views – a typically slow moving process – reflect an environment where capturing opportunities brought about by substantial swings in valuations and asset prices have warranted sizeable reallocations in a short amount of time.
- We started the year overweight nominal developed market government bonds. Yet today it is our biggest underweight. We had flagged as early as March the growing risks around inflation and inflation-linked bonds have gone from a neutral to our biggest overweight. Over the course of the year we went from neutral equities to overweight at the depths of the selloff and are now back to neutral with a preference for China. We reversed a long-standing underweight on credit in April to go overweight the asset class yet are now back at neutral. For the first time, we also contrast our views not just with our long-term equilibrium allocation but also with a representative multi-asset portfolios with a similar risk profile.
- One important consequence of the joint monetary-fiscal policy revolution in our view is higher inflation over the medium term. The recent surge in the price of gold – seen by some as an asset that preserves value and defends against inflation – suggests markets are now coming around to this view. Yet we see gold as more sentiment driven and as such a tactical call. We prefer inflation-linked bonds – that are not yet fully pricing in higher inflation risks in our view. Inflation-linked bonds are also one alternative for nominal developed market government bonds. The latter's role in portfolios is fundamentally changing as interest rates stay low for even longer and with central banks implicitly or explicitly adopting policies to cap nominal government bond yields.
- Our latest strategic views reflect our *2020 Midyear investment outlook*: decreased allocation for nominal government bonds, a preference for inflation-linked bonds and private markets as potential portfolio diversifiers and deliberate geographical equity exposures to prepare for a bifurcated world with two poles of growth – one U.S.-centric and one China-centric.
- In our latest Capital market assumptions update, richer equity valuations following the sharp rebound in prices have driven our expected returns lower. We are now mildly underweight developed market equities in favor of Asian emerging markets on a strategic horizon even as we lean into value-oriented markets such as Europe on a tactical basis. Credit remains attractive in the near-term underpinned by central bank support and stable rates. Yet we cut our strategic overweight on credit as the tightening in investment grade credit spreads means they no longer provide the same compensation for any increase in rating downgrades. We still like high yield credit for income.

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Sizeable reallocations

The Covid-19 shock turned on its head the economic trajectory that markets had priced in at the end of last year, precipitating an urgent need to revisit strategic asset allocations (SAAs). We argued as early as March at the depths of the market selloff that the impact of the pandemic and the policy response were likely to be severe enough to warrant an overhaul of how to position portfolios to be resilient to the accelerating structural changes. Market prices, asset valuations and economic projections have seen big swings in the space of two quarters. This has – in turn – had a sizeable impact on our expected returns and asset views over the course of the year.

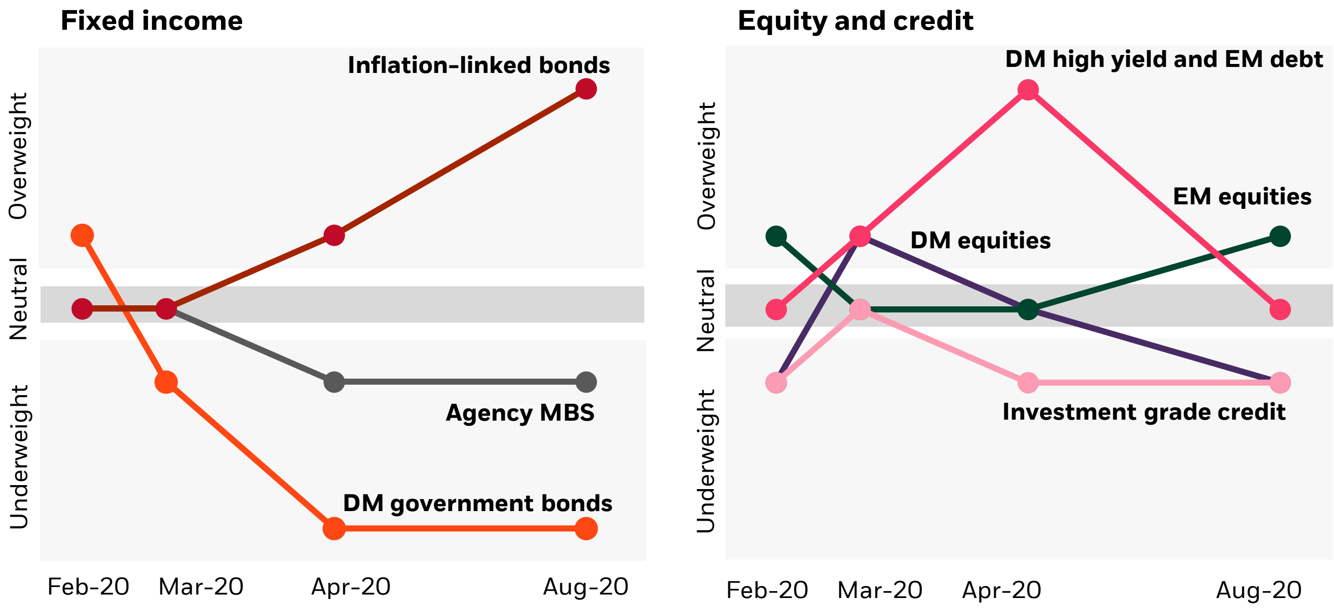
The charts below highlights how our asset views – based on our CMAs – have evolved from the start of the year to now. They highlight how typically slow-moving strategic asset allocation decisions need to be taken more quickly than usual to ready portfolios to be resilient to the new investment landscape and respond to potential price dislocations. In February, we favored a barbell approach in our SAAs comprising equities and government bonds and preferring both to credit. We had flagged the risk of government bonds losing their appeal as portfolio ballast as yields approach their perceived lower bounds. Yet we were overweight the asset classes due to our conviction that U.S. Treasuries remained diversifiers thanks to their higher yields. Our focus on constructing downside-aware portfolios by incorporating uncertainty in return assumptions – a core tenet of our process – informed the barbell approach.

By March the story had changed dramatically. A quick and fierce selloff in risk assets, reminiscent of the 2008 global financial crisis (GFC), was underway on fears of the economic cost of the coronavirus outbreaks and containment measures. Yet we held a view that this would not be a repeat of the GFC as long as the policy response was sizeable and swift because the economy and financial system were on firmer footing. We wrote in April 2020 that the unprecedented policy response would make the cumulative impact of the pandemic likely a fraction of that seen after the GFC even if the initial contraction was larger. Q2 GDP data have helped confirm this. We argued that strategic investors could turn the crisis into an opportunity by adding exposure to risk assets at the expense of government bonds where we reversed our overweight. We made case for investors to lean back into equity exposures and significantly upgraded credit, with the sharp widening of spreads more than offsetting the risks of defaults and rating downgrades then. We introduced inflation-linked bonds to portfolios – a view that has become markedly more pronounced in our latest update.

The size and scope of the policy response has driven the rebound in risk assets from the March lows – and it has also led to another revamp of our views. Our latest asset views – shown by the dots toward the right on each chart below – have moved to a substantial underweight in developed market government bonds and overweight in inflation-linked bonds. We are now mildly underweight global investment grade credit and developed market equities after the sharp rebound in valuations, preferring developed market high yield for income. We still see an important role for private markets and Chinese assets in strategic portfolios.

Evolving views

Our fixed income, equity and credit strategic views since the start of the year, August 2020



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.

Sources: BlackRock Investment Institute. August 2020. Data as of June 2020. Notes: The charts show how our asset preferences on a 10-year horizon from an unconstrained U.S. dollar perspective have changed through the course of the year. Our February 2020 views represent our asset preferences based on our capital market assumptions as of Dec 31, 2019. The March 2020 views show asset preferences based on CMAs as of March 26, 2020 and the May 2020 views represent preferences based on CMAs as of April 13, 2020. Developed market government bonds and EM equity allocations include respective China assets. The "overweight", "neutral" and "underweight" refer to relative asset class tilts against a long-term equilibrium allocation as shown on our capital market assumptions website. Index proxies are in the appendix.

Seeking new portfolio ballast

We are in the midst of a policy revolution across many dimensions – central banks are bypassing the financial system to "go direct" to businesses and consumers, the lines between fiscal and monetary policy have been blurred, and there is greater government intervention in markets and in corporate governance. Such an unprecedented policy response was needed to stave off permanent economic scarring from the pandemic. Yet the impact of the policy revolution is likely to be much longer lasting than just a few quarters.

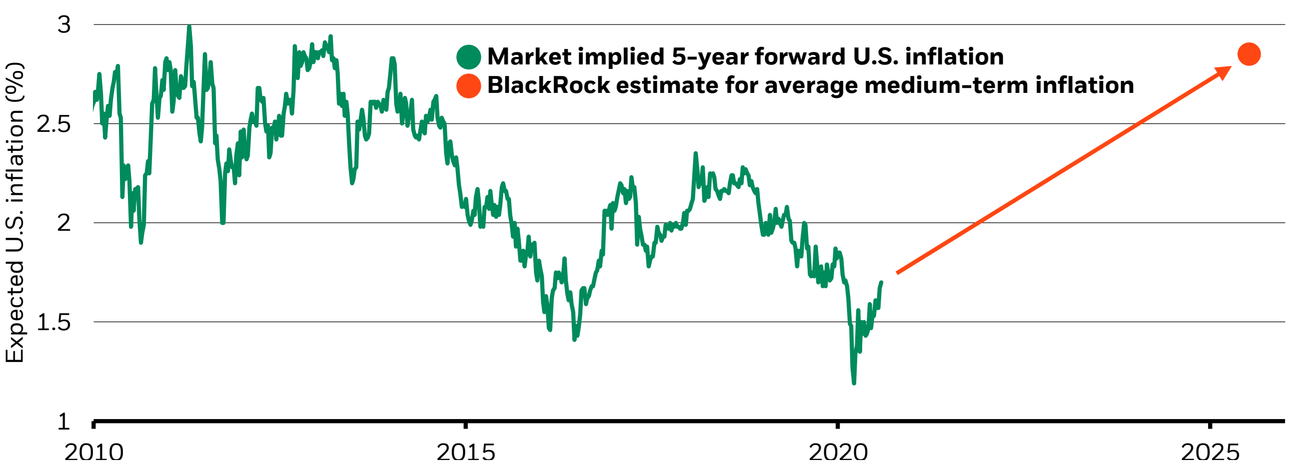
One potential consequence of the policy revolution that could become an important driver of strategic and tactical asset allocation views is the likelihood of higher inflation in the medium term. The near-term focus on the disinflationary forces of the demand shock in the aftermath of Covid-19 misses the bigger picture in our view. The impetus for higher inflation in coming years is likely to come from a combination of structurally easier monetary policy and unprecedented fiscal expansion. Both the Federal Reserve and the European Central Bank are conducting strategy reviews that are poised to shift their reaction functions to tolerate higher inflation and make up for past misses. Add to this forces such as deglobalization that amount to a negative supply shock and inflation expectations could start to ratchet higher. The build up of debt to pay for fiscal packages means it will likely be politically more palatable for economies to inflate their way out of debt rather than reintroduce austerity measures. All of the above suggests to us that we are poised for a shift to a regime of higher – and more uncertain – inflation from one marked by low and stable inflation. Our expectation for U.S. average inflation in the medium term is significantly higher than current market pricing. See the chart below. We believe increased fiscal and monetary policy coordination – without a clear exit strategy and proper guardrails – raises the risk of uncontrolled deficit spending and monetary expansion, potentially leading to higher inflation as we outlined in *Policy revolution*. This is not our base case but bears monitoring in coming years.

The policy revolution's most direct impact on our asset views? Reinforcing our underweight on developed market (DM) government bonds. Their role as portfolio ballast against equity selloffs is challenged at yields near perceived lower bounds, as we argued last year in *Bonds and ballast: testing the limits*. Now, interest rates have been pressed further to the floor. Yield curve control – already rolled out in some countries and being openly debated in others – could effectively keep government bond yields stuck near lower bounds, reducing volatility and the range of return outcomes. Our portfolio construction process now accounts for the existence of effective lower bounds on yields. The diversification appeal of nominal government bonds in portfolios dwindles when yields are close to their assumed lower bounds.

What assets could play the role of portfolio ballast instead? There is no one-for-one alternative – no other asset class offers the same liquidity and depth. We still see a role for government bonds but prefer a more targeted approach. We believe a mix of other assets will be needed, underscoring the importance of taking a cross-asset, whole portfolio view to resilience. Gold's recent rally is perhaps indicative of investors seeing inflationary pressures build and seeking out alternative risk-off hedges. Yet we find it hard to justify a strategic allocation to the precious metal as we believe it is more driven by sentiment and hence more akin to a tactical call. The lack of a fundamental driver of valuation makes it hard to model forward returns for gold in our view. We prefer other assets to build longer-term resilience such as inflation-linked bonds that could offer the added potential benefit of being negatively correlated with equities in an environment where nominal yields are capped. Private markets could also play a role as the asset class affords investors the ability to shape more bespoke exposures not typically found in public markets.

A higher inflation regime

Market implied rates of forward U.S. inflation vs. BlackRock inflation estimate, August 2020



Forward-looking estimates may not come to pass.

Sources: BlackRock Investment Institute and the Federal Reserve with data from Refinitiv Datastream. August 2020. Notes: The chart shows market pricing of expected average inflation over the five-year period starting in 2025. We show it using the five-year/five-year inflation swap that shows market expectations of average five-year forward inflation five years from now. The orange dot shows our current estimate of average U.S. CPI for the same five-year period i.e. 2025-2030.

A new landscape

A significantly changed economic and policy landscape filters through to corporate fundamentals in a myriad of ways. Our CMAs across asset classes have changed significantly since the update at the end of 2019 that reflected a very different outlook than the one facing investors today. Valuations – the primary driver of long-run returns, in our view – have seen extraordinary moves in just two quarters. Such swings inevitably lead to sizeable shifts in expected returns – and asset preferences – even for strategic horizons. We break down the contributors to equity and credit returns for our latest update and contrast them with the prior two quarters in the chart below.

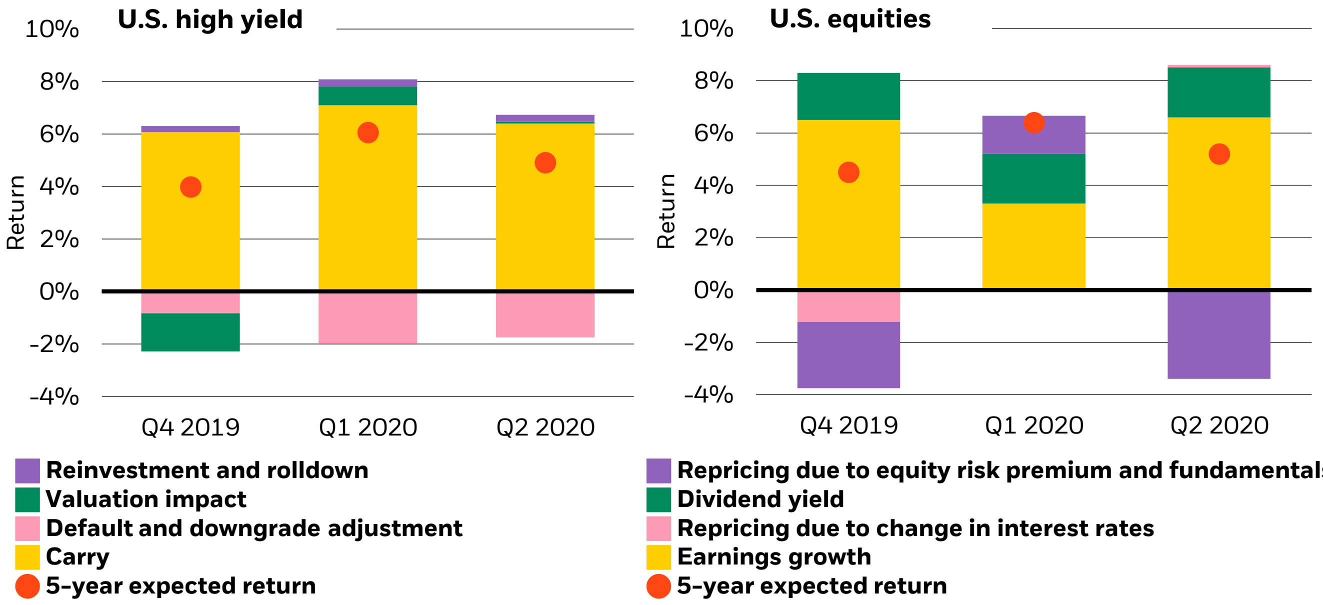
Equity and credit markets have scrambled to digest the post Covid-19 landscape without a clear historical playbook or much company guidance. We have meaningfully downgraded the outlook for corporate fundamentals. See the right panel below. We slashed our earnings estimates beyond the near-term consensus view, particularly in more cyclical markets to mirror our economic outlook. Yet equity market pricing also depends on the longer-term impact on earnings relative to prior expectations. We see a sharp earnings shock in 2020 and a gradual recovery over several years to pre Covid-19 levels. But the deepest blow is likely behind us, in our view. The recovery in earnings now depends on the restart of economic activity globally and successful implementation of policy stimulus. The “even lower for even longer” outlook for interest rates is broadly supportive of equity valuations, in our view.

An important element of the portfolio revolution we discussed earlier has been greater government intervention in the private sector. For example, some companies that have accepted state funding during the pandemic are restricted in paying dividends and share repurchases. This year’s cuts in dividends payouts have reduced equity income at a time when income from bonds is anemic at best. The key will be how persistent such cuts are and when payouts can resume. Dividend payouts have historically recovered quickly, but this is not a normal downturn and the government intervention we are seeing raises the risk of a slower recovery in dividends payouts.

Defaults and rating downgrades are likely to rise in the more challenging economic landscape – a key reason for higher assumed losses across our expected returns for credit. See the left panel below. The significant widening in credit spreads offset the increase in expected losses at the end of the first quarter, spurring our upbeat view on credit and an overall overweight on the asset class. The starting point for credit – particularly investment grade – is trickier at the end of Q2 given the swift repricing in the past few months. Spreads have tightened significantly since March, buoyed by unprecedented central bank bond purchases that have buoyed risk sentiment. We have cut our overweight stance on investment grade credit – and on credit overall. We still like high yield credit for its income potential in a low-return world, keeping us overall neutral on the broader asset class.

Breaking down our expected returns

Change in expected returns drivers for U.S. high yield and U.S. equities as of December 2019, April 2020 and June 2020



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.

Source: BlackRock Investment Institute, data as of 30 June 2020. Notes: Chart shows the changes in the drivers of our 5-year forward expected returns for U.S. high yield and U.S. equities as reported at 31 Dec 2019 (Q4 2019) at 14 April 2020 (Q1 2020) and at 30 June 2020 (Q2 2020). For high yield, the total expected return is broken down into expected loss due to default and downgrades and expected returns due to carry, valuation and rolldown or reinvestments of coupon income. For equities, the total return is broken down into repricing due to changes in interest rates, changes in the equity risk premium and the impact of changing macroeconomic assumptions such as growth and inflation (fundamentals), earnings growth expectations and dividend yields. Indexes used: Bloomberg Barclays U.S. High Yield Index and MSCI USA. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. There can be no guarantee that any forecasts made will come to pass.

Revamping the whole portfolio

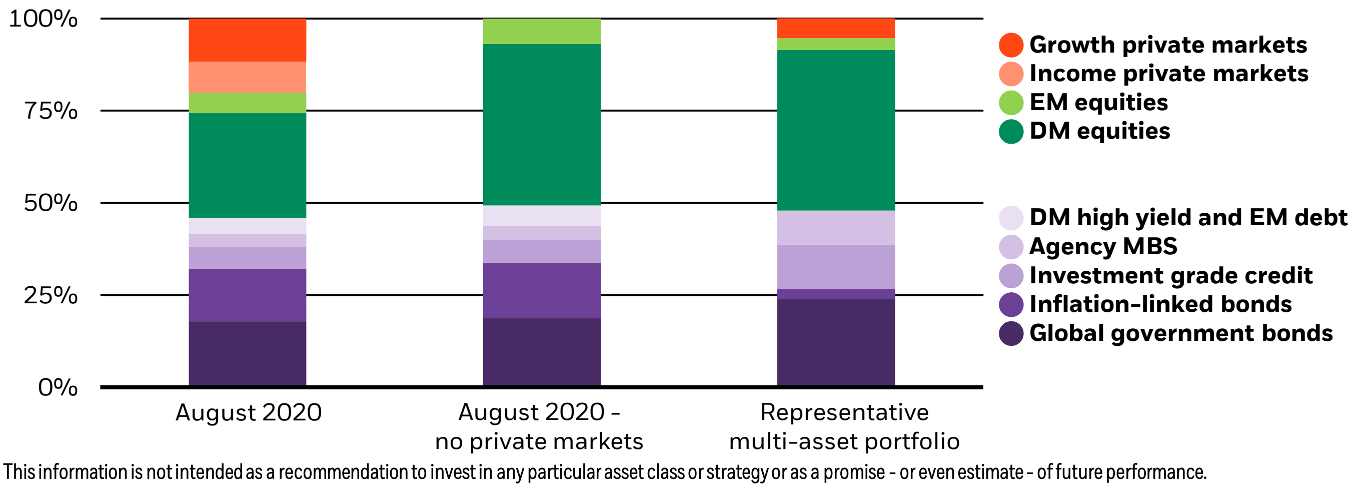
We have long emphasized that the strategic asset allocation decision is the most important driver of whole portfolio returns. This is even more pertinent with Covid-19 fundamentally reshaping the investment landscape. Anchoring investment views to the past is becoming less relevant as structural trends such as rising inequality, deglobalization, the policy revolution and sustainability race toward us. Our CMAs – the linchpin of our strategic asset class preferences – capture the effects of these structural shifts on future asset returns. Our strategic asset views represent the real portfolio implications of our CMAs and our latest research. The chart below shows our current unconstrained U.S. SAA on a 10-year horizon with and without private markets. We contrast this against a representative multi-asset portfolio with a similar risk profile. This portfolio – based on a BlackRock industry survey – is intended only as an approximate guide of average industry practice and is not an actual portfolio. A few distinguishing features of our SAA:

- **Private markets**: They are a source of attractive returns and a source of resilience during times of public market volatility, in our view. One lesson from the GFC was that flexible portfolio construction allows private market investors to capitalize on market dislocations. We have shown in the past how institutional investors may have room for relatively large allocations, depending on risk tolerance. Private markets may not be suitable for all investor types, particularly those with high liquidity needs such as mature defined benefit pensions. They are also a highly complex asset class that typically entail higher governance costs because of due diligence and assembling a large team of specialists. Certain private market assets also have a relatively short history making performance during downturns harder to assess. The ultimate sizing of private markets is highly dependent on investor-specific objectives.
- **Geographical diversification**: One pillar of our investment outlook is that global growth will increasingly be led by two poles – one that is U.S.-centric and one China-centric. We believe deliberate geographic equity exposures - balanced across regions tied to the U.S. and China - are vital for real portfolio resilience in a deglobalizing world. We believe China is under-represented in global indexes – and a benchmark-weighted strategic allocation to China based on current index weights would amount to an effective underweight. We believe those allocations should be significantly higher: we are overweight Chinese government bonds and prefer Chinese equities to DM peers. See here for more on our broad views on Chinese assets.
- **Sustainability**: The pandemic has also underscored our belief that sustainability is an important return driver and that 'green' companies should be resilient in adverse markets while also having upside return potential. We think sustainability isn't yet fully appreciated or priced in markets. Rather, it will drive investment flows and repricing in decades to come. We plan to publish work on incorporating sustainability directly into our CMAs in coming months.

Our bottom-line: We hold more private markets, both growth and income. One reason for our lower allocations to public equity and credit relative to the representative portfolios is that we prefer opportunities in private markets where our allocations are materially higher. If private markets were excluded from the investable universe that allocation would largely go back into DM equities as see in the middle bar below. We prefer a smaller allocation to nominal DM government bonds and investment grade credit, but a larger allocation to inflation-linked bonds. Finally, our equity exposure is tilted more toward emerging markets. See our interactive CMA website for full details.

Strategic asset preference revamp

BlackRock 10-year SAA with and without private markets vs representative multi-asset U.S. portfolio, August 2020



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance.
Sources: BlackRock Investment Institute, August 2020. Data as of 30 June 2020. Notes: The bar charts on the left show our hypothetical, unconstrained, US dollar-denominated equity-bond SAA built using our portfolio construction approach and CMAs for August 2020. The middle bar assumes private markets are excluded from the investable universe. The U.S. representative multi-asset portfolio shows the average of a client survey conducted by the BlackRock U.S. Wealth Advisory group. The survey comprises 3,319 advisor models with a similar risk target of 8% and similar objectives as our unconstrained SAA. The allocation is illustrative only, and intended to be an approximate guide of average industry practice. It does not represent any actual portfolio. Global government bonds and EM equity allocations include respective China assets. Income private markets include infrastructure debt, direct lending, real estate mezzanine debt and US core real estate. Growth private markets include global private equity buyouts and infrastructure equity. The hypothetical portfolio may differ from those in other jurisdictions, is intended for information purposes only and does not constitute investment advice. Index proxies are in the appendix. Indexes are unmanaged. It is not possible to invest directly in an index.

Appendix

Indexes

Global govt bonds = Bloomberg Barclays Global Treasury index

Japan govt bonds = Bloomberg Barclays Global Treasury Japan Index

Euro area credit = ICE BofA Merrill Lynch 10+ Year Euro Corporate Index

Global high yield = ICE BofA Merrill Lynch Global High Yield Index

Euro area govt bonds = Bloomberg Barclays Euro Aggregate Treasury Index

U.S. credit = Bloomberg Barclays U.S. Credit Index

Global IG credit = Bloomberg Barclays Global Aggregate - Corporate

Inflation-linked bonds = ICE BofA Merrill Lynch Global Inflation-Linked Government Index

Euro area inflation-linked bonds = ICE BofA ML EMU Direct Government Inflation Linked Index

US TIPS = Bloomberg Barclays US Government Inflation-Linked Bond Index

US agency MBS = Bloomberg Barclays US MBS Index

DM high yield = Bloomberg Barclays Global High Yield Total Return Index

EM debt, local = JP Morgan GBI-EM Index

EM debt, hard = JP Morgan EMBI Global Diversified Index

Japan equities = MSCI Japan index

European equities = MSCI Europe index

EM ex-China equities = MSCI Emerging Markets ex-China index

DM equities = MSCI World index

EM equity = MSCI Emerging Markets Index

Onshore Chinese equities = MSCI China A Inclusion NET Index

We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.

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