BlackRock.

Portfolio perspectives
August 2021

Getting granular

Updated capital market assumptions and strategic implications of our expected yield curve and sectoral views

BlackRock
Investment
Institute

Summary

- The volatility we have seen just in the two months since we published our midyear investment outlook reflects - in our view - the unusually wide range of divergent yet plausible economic outcomes that potentially lie beyond the post-Covid restart. We stand by the broad themes we outlined in our outlook and hold conviction in our asset views. Our broad strategic asset views – largely unchanged since our last update in May – still tilt towards equities over credit and government bonds, even after the strong rebound we have seen since the equity market's lows of March 2020.
- Our views are underpinned by three important themes: the *new nominal*, or the muted central bank policy response to higher inflation, China as a distinct asset class and global growth engine and the journey to net zero. In this *Portfolio perspectives*, we dig a little deeper into the strategic implications of those themes.
- Our overweight on developed market (DM) equities is further bolstered by taking a more granular, sectoral approach as we highlight below. We prefer inflation-linked bonds to DM nominal government bonds due to our medium-term inflation expectations and the diminished diversification role of nominal bonds. The lower-for-longer rate environment also boosts the appeal of private markets for eligible investors.
- We believe that capturing the nuances and exploiting the investment opportunities arising from our themes warrants a more granular approach to portfolio construction. We advance our toolkit accordingly in two ways: on interest rates, we build on our work on fully reflecting the implications of the *new nominal* in our framework by taking explicit views across the yield curve. On equities, we use sectors as the unit of analysis to inform our overall views. We also reiterate our stance on China amid concerns around a regulatory clampdown on private industry. The overall case for Chinese assets remains intact and is particularly strong for government bonds.
- The fall in long-term yields through the second quarter – a reversal from the moves earlier in the year – have further eroded our expected returns across government bonds and credit. Yet we believe the interest rate environment lends itself to more granularity because the *new nominal* is effectively all about varying views across different parts of the yield curve. We expect the yield curve will be steeper over a five-year horizon than the market is currently pricing. The implication? A preference for shorter-dated nominal government bonds over longer maturities within our overall underweight on the asset class.
- The new nominal means we expect short-term yields will likely stay low as central banks keep policy accommodative, yet longer-term yields to gradually rise on the back of higher medium-term inflation and a revival of term premia – or the compensation investors demand for holding riskier longer-term bonds. Our expectation of a structural shift to higher medium-term inflation means we prefer longer-dated inflation-linked bonds over shorter-dated counterparts.
- In equities, the post-Covid environment underscores the importance of a more granular, sectoral approach. Why? Such an approach allows investors to better tap into structural themes and exploit sector divergences in the restart, in our view. For instance, we believe climate change and the green transition will impact all assets, but it will be most pronounced at the sector rather than broad market level. Some sectors may benefit from being aligned with the green transition, as solution providers or being less exposed to climate risks, including tech and healthcare. Others such as energy and utilities may face longer-term challenges even if restart dynamics brighten their near-term appeal.
- We recognize that precise implementation of more granular views in practice can differ widely among different types of investors. The extent of granular allocation - in either bonds or equities - may be limited by the governance requirements, costs, and other complexities and constraints.

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Our latest strategic views

The overall direction of our strategic tilts has remained stable amid a noisy macro backdrop. Market sentiment has swung between extremes since our last update in May as fears of runaway inflation gave way to concerns over deflationary spirals in the matter of a few months. These swings reflect - in our view - the unusually wide range of significantly divergent yet plausible economic outcomes that potentially lie beyond the economic restart. Having an anchor is important in such an environment. We maintain high conviction in our *new nominal* investment theme that implies low real yields - a positive for risk assets – and see market overreactions may create opportunities to readjust portfolios. The new nominal, alongside our two other investment themes – *China stands out* and *the journey to net zero* – continue to guide our views.

Our strategic tilts are summarized in the chart below. We maintain a higher allocation to equities than we would through typical periods of rising inflation as we believe the policy revolution has diminished the risk of a sharp rise in discount rates hitting valuations across asset classes. We continue to prefer equities over credit and government bonds. We already preferred DM equities over EM. This preference has been further bolstered by two factors: first, incorporating climate change in our return expectations brightens the relative appeal of DM indices whose sector composition is better aligned to the green transition and second, a more granular, sectoral approach to equity allocations that we have now adopted allows us to lean more heavily into sectors such as tech and healthcare that we favor. See more on page 6. In fixed income, we prefer inflation-linked bonds to DM nominal government bonds as portfolio ballast. The lower-for-longer environment boosts the appeal of private markets for eligible investors, in our view.

We believe the low level of long-term bond yields is inconsistent with both restart dynamics and our macro outlook. We stick to our underweight in nominal DM government bonds and believe the direction of travel for nominal yields is higher. We stay overweight equities on a strategic horizon partly on the view that valuations do not look stretched in terms of the equity risk premium – our preferred gauge that considers the low interest rate implications of the new nominal. We also see earnings growth driving returns, though the pace of earnings growth will likely moderate as the growth spurt of the activity restart settles into an economic expansion.

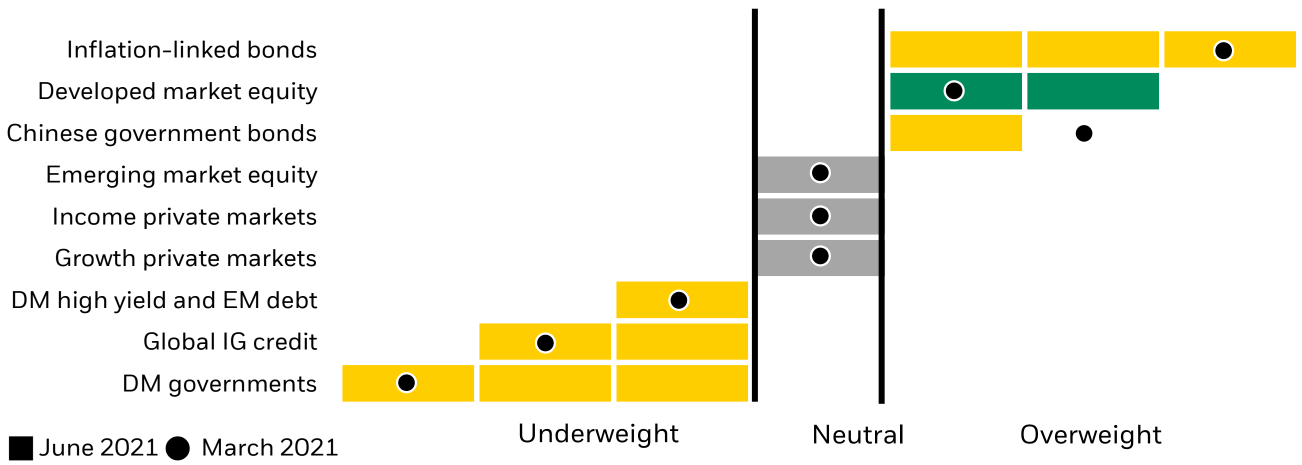
The strategic case for Chinese equities has come under scrutiny amid signs of a regulatory clampdown on certain private industries. The recent volatility underscores, in our view, the risks around policy implementation. This is a key reason why we maintain a high level of uncertainty around our mean return estimates on Chinese equities. At the same time, the income and portfolio ballast properties of Chinese government bonds remain attractive at a time when DM government bonds ballast properties have been diminished. The potential role Chinese assets can play in strategic portfolios highlights a key tenet of our broader investment views: portfolio resilience will likely be driven by deliberate diversification across countries, sectors and regions rather than broad asset class correlations.

Finally, the path to net-zero carbon emissions now has a starting point and potential destination – but there is no clear roadmap yet for getting there. Some of the coming changes may be abrupt – and add to supply and demand disruptions among commodities. We see opportunities along the way, particularly in private markets as we see private capital playing a key role in financing the climate transition. We see twists and turns in the journey to a more sustainable world. Our base case is for an improved outlook for growth and risk assets versus a do-nothing scenario yet acknowledge that uncertainty around this is very high. Monitoring the transition is key as we see it affecting the risk premia of all assets, in our view.

How different types of investors reflect the granular approach we discuss is likely to vary significantly based on their approach. Governance costs, constraints and other complexities could limit how granular their portfolios can go.

Still prefer equities over credit and government bonds

Hypothetical U.S. dollar 10-year strategic allocation vs. our equilibrium view, August 2021



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, August 2021. Data as of 30 June 2021. The chart shows our asset views on a 10-year view from an unconstrained U.S. dollar perspective against a long-term equilibrium allocation. 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 allocation shown is hypothetical and does not represent a real portfolio. It is intended for information purposes only and does not constitute investment advice

Deliberate yield curve views

The policy revolution in developed economies – marked by historic monetary and fiscal policy stimulus – has meant a surge in debt to record levels. Rising inflation coupled with continued fiscal spending from governments in the Western world means that we expect a revival in term premia – the extra compensation investors demand for holding long-term government bonds. The upshot: we see a steeper yield curve than markets expect as shown on the left chart below.

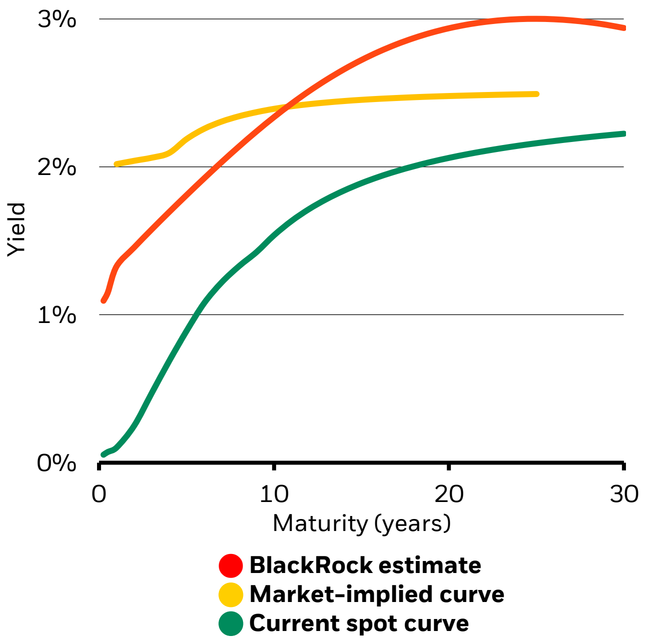
Markets have also grappled with the Federal Reserve's new framework. In June, investors extrapolated strong economic data amid the restart and assumed a policy reaction more akin to that of previous cycles to price in a much faster pace of Fed interest rate hikes than the Fed's own – and our – projections. By the end of July, such expectations were tempered significantly and had moved down closer to the Fed's view, as shown on the chart below on the right. One important implication of the new nominal for our CMAs is that our expectation of the path of short-term interest rates remains lower than what markets are currently pricing in. We expect a similar dynamic to play out in the euro area where the European Central Bank (ECB) has adopted a symmetrical 2% inflation target. We had already been assuming that sluggish inflation dynamics would spur a greater tolerance for inflation overshoots from the ECB, and a later lift-off in policy rates than the Fed. See Appendix.

We discussed in our December 2020 paper *A new playbook for higher inflation* how longer-dated DM nominal government bonds remain challenged in their ability to provide portfolio diversification. Breaking down portfolio exposures across the yield curve in terms of short-dated bonds versus longer-dated bonds allows for a more deliberate expression of our macro framework than simply taking a view on the entire asset class.

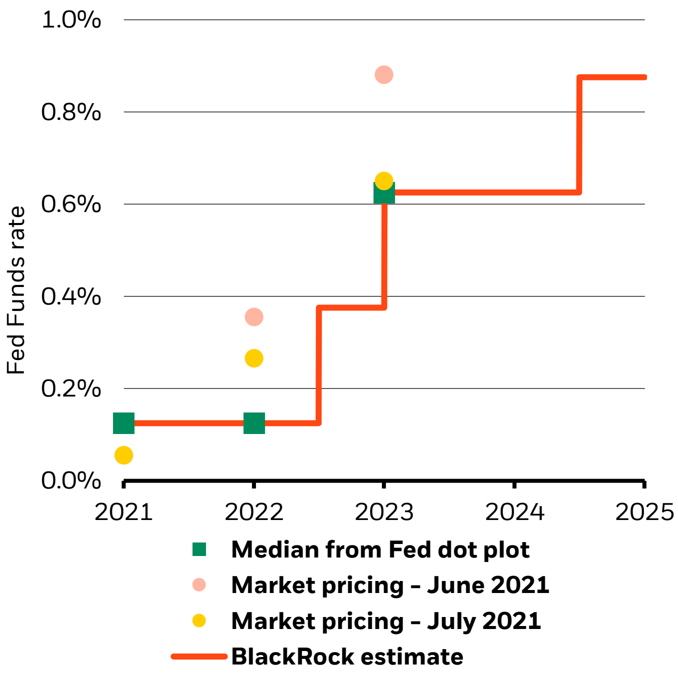
Our new nominal theme sets our expectations of the yield curve apart from what markets are currently pricing in two ways. First, we expect policy rates to remain lower for longer and second, we expect a steeper yield curve in the future than what market prices currently imply. Our estimates of nominal short-term yields stay below what the market is pricing meaning we see more return potential for shorter-dated assets than what markets expect as we see less room for yields to fall. We can better express these view if we consider shorter (1-10 year) and longer (10+ year) government bond indices and move away from all-maturity government bond indices.

Another aspect of the new nominal is that we see medium-term – a five-to-ten-year horizon – inflation expectations as too low. The overhaul of central bank reaction functions along with supply-demand frictions as a result of re-globalisation and the green transition will push inflation moderately higher, in our view. We prefer a higher allocation to longer-dated inflation linked bonds compared to a market-cap weighted allocation in an all-maturity index given our expectation of higher medium-term inflation – something we believe markets may be underappreciating.

Eyeing steeper curves...
Spot U.S. yield curve vs estimates, August 2021



...amid a slow Fed policy response
Expectations of U.S. policy interest rates, 2021-2025



Past performance is no guarantee of future results. Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, Federal Reserve and Federal Reserve Bank of New York, with data from Refinitiv Datastream, August 2021. Notes: The left chart compares our estimate of the shape of the U.S. yield curve in five years' time with a market-pricing implied estimate and the spot yield curve. The right chart shows our expectations for the federal funds rate, the Fed's policy target (dot plots) and market-implied pricing of the rate path as of the end of June 2021 and the end of July 2021. Market pricing is based on futures on the U.S. dollar Secured Overnight Financing Rate. The BlackRock assumption is part of our economic estimates in our capital market assumptions. The Fed median dot plot comes from the June 2021 Summary of Economic Projections..

China stands out

We discussed in detail in our May 2021 paper *The role of Chinese assets* how the acceleration of structural trends in the aftermath of the Covid shock helped further crystalize our strategic preference for Chinese assets. China's regulatory clampdown on industries such as tutoring and tech has since unnerved global investors in recent months. Recent developments are an example of why the risk premium for investing China is higher than most DMs. Yet we do not believe this is the time to step away from China. The broader strategic case we have laid out for Chinese assets – that they should play a larger role in strategic allocations that they currently do – remains intact, in our view.

Longer term, China remains a distinct pole of global growth, and we see it as an investment destination separate from both EM and DM. Our preferred strategic allocation to Chinese assets – both equities and bonds – remains higher than that suggested by their weight in broad global benchmark indexes. We recognize implementation of our asset views will differ across investor types and geographies, depending on objectives, constraints and regulation.

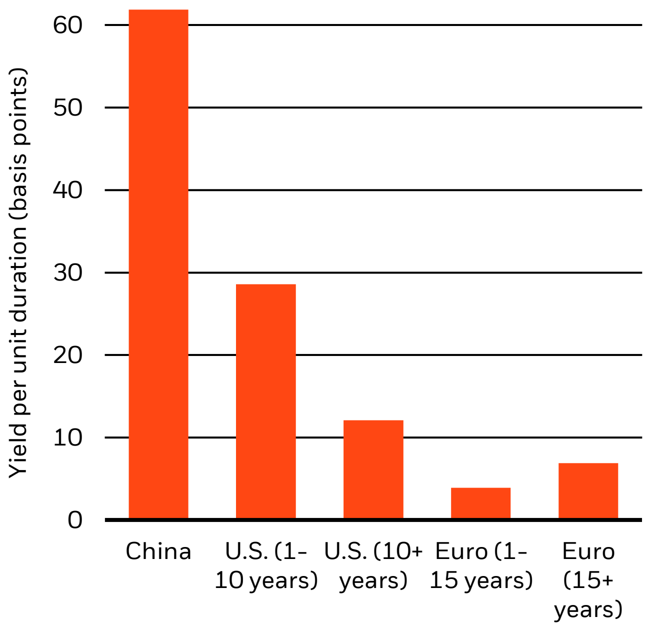
One concern has been whether recent regulatory actions are evidence of underlying "anti-market" intentions that contradict rhetoric from policymakers aimed at enticing foreign capital. We do not believe this is the case. Why? For one, actions elsewhere – such as in credit markets where authorities are encouraging a greater tolerance of credit defaults – pave the path toward a clearer market pricing of risk. Second, authorities' reaction to market volatility was telling. The Politburo of the Chinese Communist Party, made up of the country's most senior leaders, removed certain previously used hawkish regulatory language from their July meeting statement – a sign, in our view, of cognizance of the market impact and desire to calm sentiment. Lastly, we believe policymakers want to encourage more friendly foreign and private capital conditions as they see it key to meeting growth targets and developing onshore funding markets.

The case for Chinese government bonds, in particular, is undimmed and the asset class remains a key strategic overweight in a low-yield world, in our view. The charts below highlight their appeal. They show that the income potential in Chinese government bonds relative to duration risk is considerably higher than DM peers – a key driver of our higher expected returns. Differences in yields across sovereign bond markets can be due to factors such as perceived sovereign risk, expectations for domestic economic conditions and monetary policy and market supply and demand.

The post-pandemic policy revolution in developed economies that has led to a surge in debt to record levels stands in contrast to what we are seeing in Asia's largest economy. China is pursuing a more orthodox policy with both real and nominal interest rates positive and somewhat high when compared to global peers. We see China as an appealing investment destination for global investors searching for yield in bond markets because of this distinct policy approach. Why is China doing this? In our view, China believes that reducing risks in its financial system by limiting borrowing binges and moving to a somewhat more efficient allocation of capital is fundamental for it to achieve its ambitions in the coming years and decades.

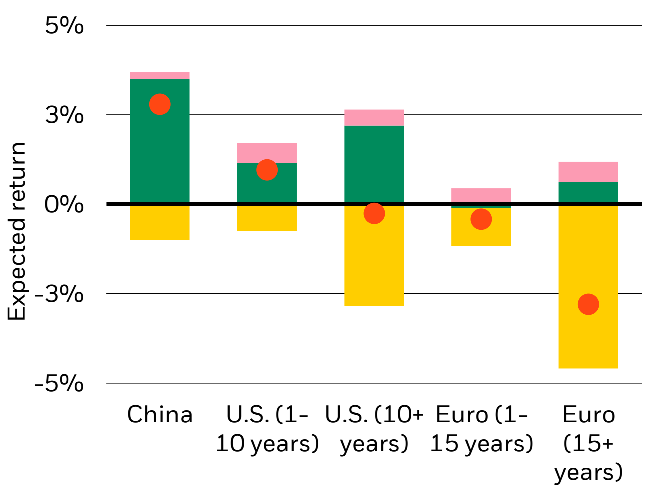
Higher income potential…

China vs DM, yield per duration, August 2021



…maintains China bonds' relative appeal

Breakdown of our government bond CMAs, August 2021



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. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index . Past performance is not a reliable indicator of future results. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2021. Notes: The left chart shows the yield per unit duration – or an index's yield divided by the average duration of the constituents – that measures income received relative to duration risk. The right chart shows the breakdown of the underlying components that drive our expected returns across regional government bond benchmarks . See the methodology page on our capital market assumptions website for more.

Why a sector lens matters

The economic restart has driven high sector dispersion, due to the near-term economic environment and structural trends accelerated by the pandemic, in our view. The vaccine-led activity restart unfolding globally is very different from a typical business cycle recovery. There is no investment playbook to follow as this kind of forced shutdown on a global scale, a massive fiscal and monetary policy stimulus and the ongoing restart has little historical precedent.

Rising earnings growth expectations have helped offset the impact of higher equity prices on our overall expected equity returns. In our latest CMA update, our expected equity returns in the latest update have fallen only slightly for the U.S., Europe, UK and EM ex-China – a reflection of restart dynamics. We see the sharp spurt in activity underway as the global economy emerges from lockdowns settle into an expansion around trend growth further down the line. The chart on the left below illustrates this pattern – earnings growth expectations beyond the immediate forward 12-month period is expected to moderate across regions, according to the latest Refinitiv data. Regional equity allocations have helped capture some of the divergences.

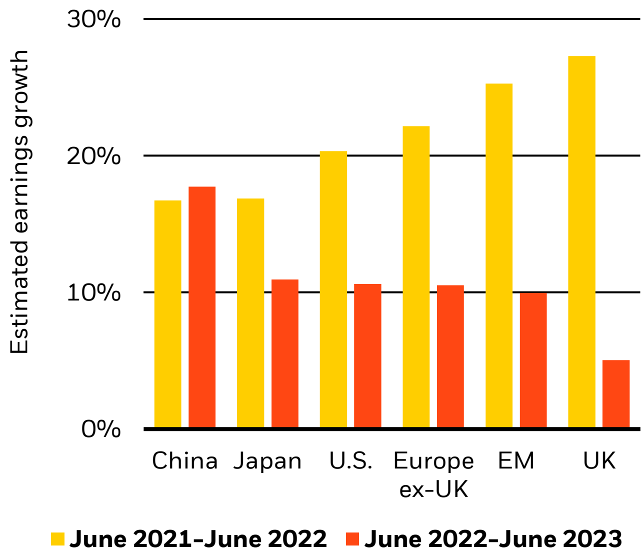
Yet one important trend under the surface is that sectoral divergences are even more stark than regional ones. We are introducing a framework for sector-level CMAs for the U.S. and Europe that we believe can help better exploit unfolding sectoral shifts in the post-Covid world. We see both medium- and long-term reasons for this. On the former, the restart has been marked by significant divergences in sector performance. The chart on the right shows how the latest forward earnings estimates for sectors within the MSCI USA and MSCI EMU stack up against each sectors' pre-Covid estimate in December 2019. It shows how sectors in the U.S. – except energy – have mostly surpassed their pre-Covid estimates while peers in the euro area are just reaching those levels now, showing the broadening restart and how Europe is now picking up the baton from the U.S.

There is significant divergence between sectors within the same region. Part of this can be attributed to a rebound in cyclical sectors geared to growth yet there is more to it. Some sector dynamics can be explained by the unique nature of the pandemic shock. Service-based, high-contact sectors suffered through the lockdowns and are still lagging goods-based sectors. The restart is now fuelling high demand in some areas due to pent-up demand and a savings surplus but also causing supply shortages. Crucially, we see this as different to a typical cyclical rotation as growth expectations have been revised up, yet interest rates have stayed low, supporting valuations of 'long duration' sectors such as tech.

The pandemic has turbocharged the shift toward sustainability. We believe high carbon emitting sectors such as energy and utilities are highly exposed to transition risks that will likely push their cost of capital up and profitability down. The energy sector's recent strong performance reflects the near-term rebound in activity, in our view, as strong demand and supply shortages push up crude prices. We believe this may be short-lived as the transition to net zero leads to peak demand. Our return estimates for energy drop off sharply over the medium term. On the other hand, we like healthcare and tech on a strategic horizon. Firstly, we see tech and healthcare as aligned with the green transition. Secondly, both benefit from the low short rate environment we expect as part of the new nominal. We expect strong earnings growth, not just in the near-term but to persist beyond the restart. Finally, we do not see healthcare and tech as expensive versus our estimate of their long-run fair value based on the equity risk premium.

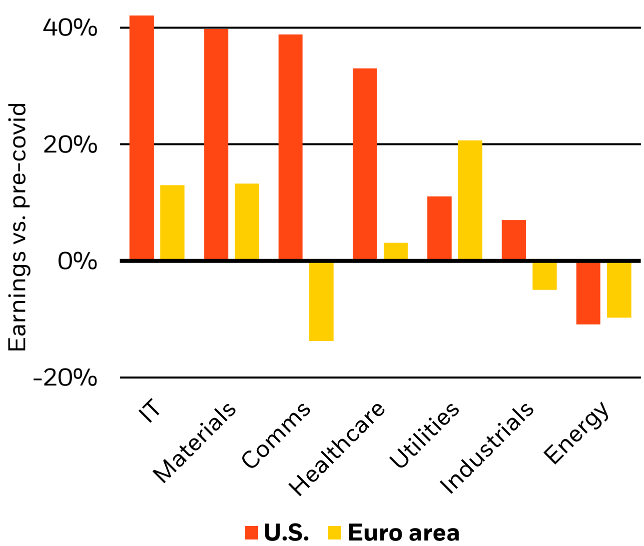
A restart, not a recovery

12-month and 24-month forward earnings estimates



High sector dispersion

Forward earnings estimates vs pre-Covid level, August 2021



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2021. Notes: The left chart shows earnings growth estimates for the 12-month period between June 2021-June 2022 and June 2022-2023. The right chart shows 12-month forward earnings for the selected sectors within the MSCI USA and MSCI EMU indexes relative to their pre-Covid trend. Respective MSCI sector indices are used as proxies. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Appendix

Index proxies

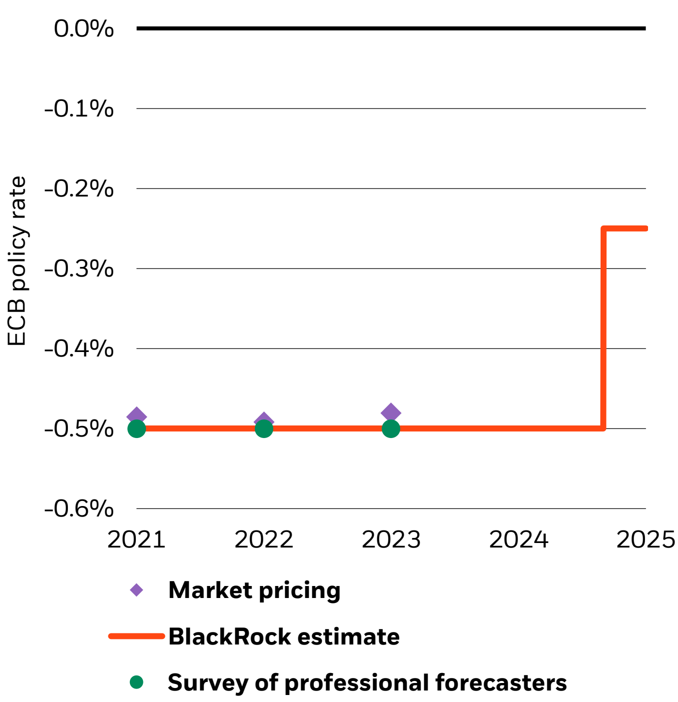
Asset	Index
Equities	MSCI Developed - US Gross TR Index
	MSCI Developed - United Kingdom
	MSCI EMU Index
	MSCI Developed Europe ex UK Gross TR Ind
	MSCI Developed - Japan Gross TR Index -
	MSCI Daily TR Gross Developed Pacific Ex
	MSCI China A Inclusion NET Index
	MSCI Emerging - China in CNY
	MSCI Emerging Markets ex China (Net)
Fixed Income (Sovereign bonds and investment grade)	Bloomberg Barclays U.S. Treasury 1-10 Yr Index
	Bloomberg Barclays U.S. Treasury 10+ Yr Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Sterling Aggregate Gilts (1-10)
	Bloomberg Barclays Asian Pacific Japan Treasury
	Bloomberg Barclays China Treasury + Policy Bank Total Return Index
	Bloomberg Barclays US Government Inflation-Linked Bond 1-10yr Index
	Bloomberg Barclays U.S. Tips Index 10Yr Plus - USD GROSS TR
	Bloomberg Barclays Euro Government Inflation-Linked 1-10 Years Index
	Bloomberg Barclays Inflation Linked Eurozone Inflation 10+Y
	Bloomberg Barclays MBS Index
	Bloomberg Barclays U.S. Credit Index
	FTSE Actuaries UK Index-Linked Gilts up to 5 Years Index
	FTSE Actuaries UK Index-Linked Gilts over 5 Years Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	Bloomberg Barclays Sterling Aggregate Corporate Bond Index
Fixed income (High yield)	Bloomberg Barclays U.S. Credit Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	JP Morgan EMBI Global Diversified Index
	JP Morgan GBI-EM Global Diversified Index
Income and growth private markets*	U.S. private equity
	Global direct lending
	Global Infrastructure equity
	U.S. core real estate
	Real estate mezzanine debt
	Hedge funds (global)
	U.S. infrastructure debt
	Developed markets infrastructure debt

* 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.

Appendix

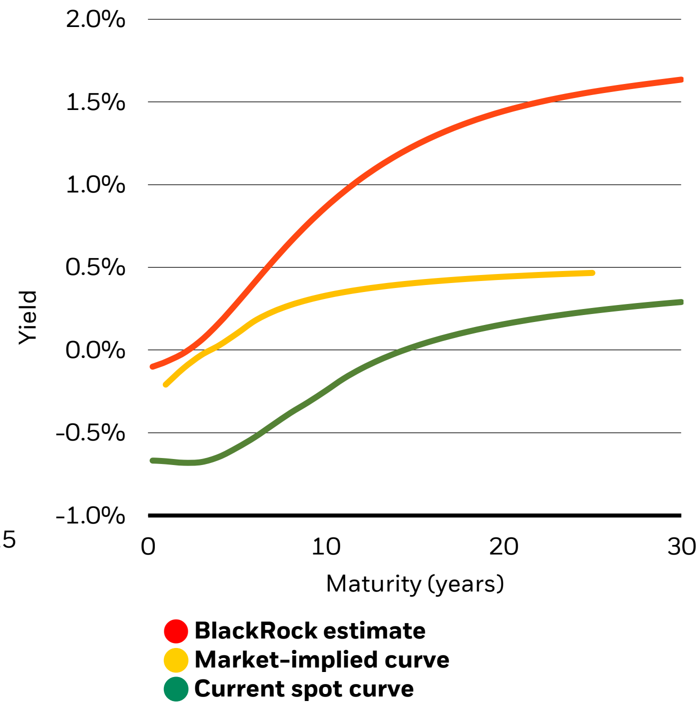
Euro area policy rates

Expectations of euro area policy interest rates, 2021-2025



Euro area yield curves

Spot euro area yield curve vs estimate, August 2021



Forward looking estimates may not come to pass. Source: BlackRock Investment Institute, European Central Bank, with data from Refinitiv Datastream, August 2021. Notes: The left chart shows our expectations for the European Central Bank's policy rate , market-implied pricing of the rate path as of end-July 2021 and the average projection from the ECB Survey of Professional Forecasters (SPF). Market pricing is based on futures on the Euro Overnight Index Swap Rate. The BlackRock estimate is part of the macro model in our capital market assumptions. The ECB Survey of Professional Forecasters: https://www.ecb.europa.eu/stats/ecb_surveys/survey_of_professional_forecasters/html/index.en.html. The right chart compares our estimate of the European yield curve in five years' time with a market-implied projection and the spot yield curve as of 30th June 2021.

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