Official Institutions Digest

Q2 2021: COVID vaccinations, restart acceleration & increasing inflation …

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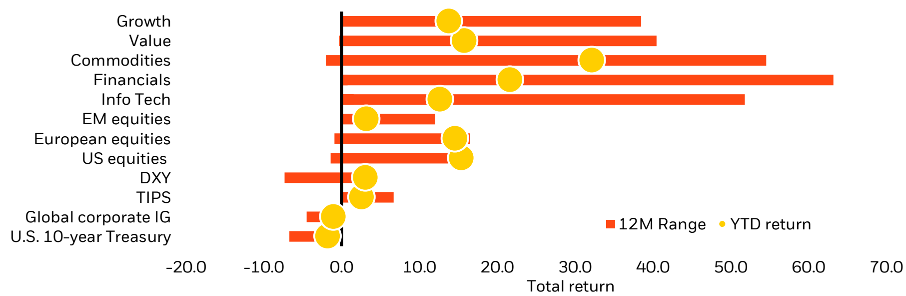
Contents

Happening in markets

As Q2 has come to a close, financial markets ended a strong first half of 2021 with some volatility amid concerns around growth outlook due to the rapidly spreading Delta COVID-19 variant. Q1 trades that benefitted from accommodative policy pulled back and interest rates reversed their Q1 increase and steepening, as investors priced in a less dovish fed on the back of sharply rising inflation. Restart-sensitive sectors (e.g. energy, financials) have been a key beneficiary of the cyclical rotation and reopening spreading beyond the U.S., while commodities continued to advance on the back of both the economic reopening and supply constraints.

Though the BlackRock Investment Institute (BII)'s base case remains that there will be some hiccups or delays to full reopening, the broad recovery remains on track with the market rally broadening to benefit both cyclical and secular growth exposures, with continued policy support keeping economic risks and imbalances at bay. But what is to come after the restart, in the post-COVID world? Most investors are pro-risk in the near term, but we see a wide range of potential macro outcomes beyond the restart, with a different playbook needed than post-Global Financial Crisis. BII key themes to watch include:

Selected asset performance



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of June 10, 2021. 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, in descending order: spot Brent crude, MSCI Europe Index, MSCI USA Index, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), spot gold, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

1. **The new nominal**: Other major economies are catching up to the U.S. economic restart. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.

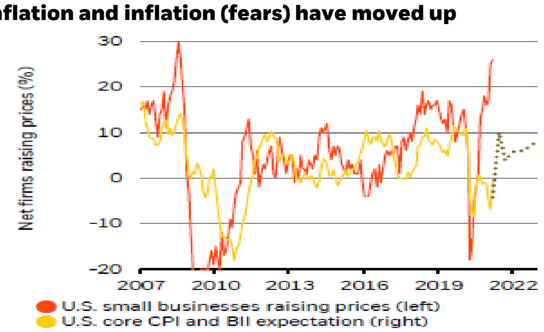
2. **China stands out**: Growth in China is starting to slow at the same time the policy stance is relatively tight. Our new Capital Market Assumptions reflect that we are breaking out China from broader EM as an asset class of its own, and thinking about how China exposures fit into portfolios. See page 4 for more China-focused think pieces.

3. **Journey to net zero:** There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. Our climate aware CMAs now take climate risk and opportunities into consideration.

Read our latest Mid-Year Global Outlook for more analysis of these themes.

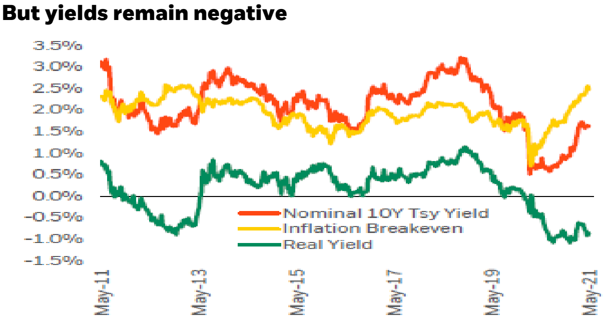
The outlook for inflation is one of the key variables investors are watching, with supply and demand side arguments supportive of the case for higher inflation as well as central bank's indication that they are willing to tolerate higher levels of inflation to catch up with undershoots. In the short-term, inflation has increased from the cyclical reopening; long-term inflation will likely be anchored by demographics and other structural factors which points to lower inflation. Nevertheless, CPI is 5.4% y/o/y in June 2021, driven reopening factors and supply constraints. Are these rising prices the start of something bigger? BlackRock's quant bond experts tackle this and other inflation questions in their recent piece *Tempting FAIT*.

Inflation and inflation (fears) have moved up



Sources: BlackRock Investment Institute. Institute of Supply Management (ISM) and Markit, with data from Refinitiv. As of March 2021.

But yields remain negative



Sources: BlackRock Investment Institute, as of May 28, 2021

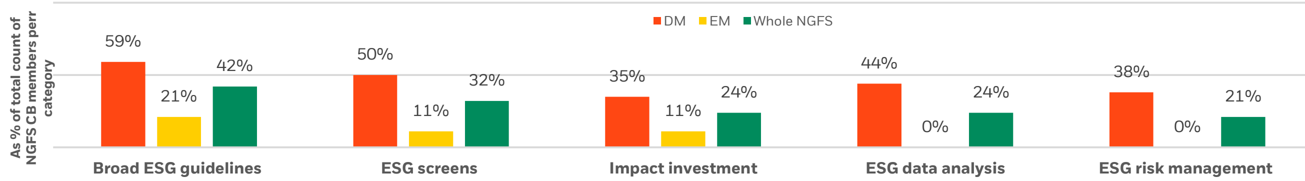
As our new nominal theme plays out, we've seen a hefty jump in inflation expectations but a more muted rise in nominal yields. BII expects a decoupling of nominal interest rates and inflation, with the knock-on impact of rising inflation on nominal bond yields expected to be lower than in the past, resulting in lower real yields. This is supportive for risk assets, including commercial real estate and infrastructure. Looking beyond real estate to address inflation concerns, our recent webcast: *Higher Inflation – turning threat into opportunity* addresses additional asset classes that offer themselves as potential inflation hedges.

Strategic Asset Allocation Corner

BlackRock's Official Institution Group's latest paper titled ***From trickle to main stream – Central banks' journey into sustainability*** examines the rapid evolution of central banks' (CBs) approaches to climate change. Only a few years ago, the consensus in the CB community had been that climate change was something for others to worry about. This began to change in late 2017 with the founding of the Network for Greening the Financial System (NGFS). While the NGFS membership has swelled to 90 members, of which 63 are CBs, and it may suggest the consensus has flipped, we observe that they are at very different stages in the journey towards fully internalizing the relevance of climate change into their actions. And most are still at a very early stage. However, the collective journey is underway and is clearly gaining speed. Through this paper, we aim to:

- Discuss how climate change gradually imposed itself not only as a legitimate but also an essential issue for CBs to consider, and where the debate stands today.
- Provide an overview of actual practices across the global central banking community, first both from the perspective of entire central banking universe followed by a detailed analysis of practices across the NGFS community more specifically.
- Offer recommendation for CBs at different stages. Those at the start of this journey should clearly define what they want to achieve by integrating climate change into their activities, in the context of their specific mandate. We argue that in all cases, CBs should develop a framework for assessing their exposure to climate change across all their activities.

Just under half of all NGFS CBs have established broad ESG Guidelines for their reserve portfolios, with CM CBs ahead of their peers in implementing ESG investing



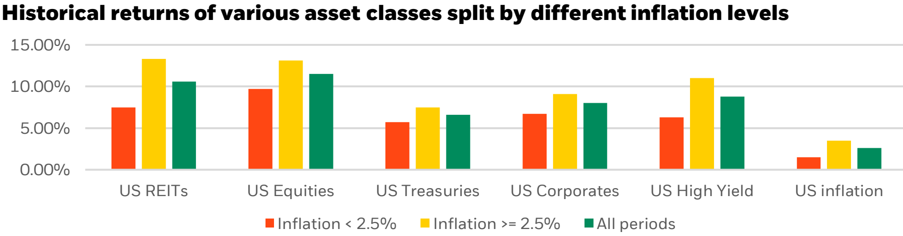
Source: Review of annual CB reports, CB speeches, news reports, as of 1/3/2021. Given the research was concluded as of 1/3/2021, the total number of examined CBs is 62, which excludes the Reserve Bank of India, which joined NGFS in April 2021.

Diversification: Why Not Real Estate Securities?

Real estate is a long-established investment asset class and many investors are used to allocating to it in their portfolios; listed vehicles such as REITs seek to address some traditional challenges of accessing real estate exposure by providing liquid and tax transparent solutions. REITs, if held for longer periods, say 5 years, seek to provide exposure to the diversification benefits of real estate in addition to relatively attractive yields, particularly in the current low yield environment, where markets are also exhibiting nervousness about rising inflation, interest rates and post pandemic change.

The chart below analyses the performance of REITs in inflationary periods in more detail: it compares the average historical calendar year returns of various asset classes versus US inflation in times of "high", i.e. in excess of 2.5%, and "low", i.e. below 2.5%, inflation. 2.5% was chosen as the threshold because it splits the observations in almost similar-sized groups. While all asset classes performed relatively better in "high" inflation periods, at 5.8%, the performance uptick was most pronounced for REITs. However, if we look at higher inflation periods, i.e. above 3%, which occurred in a third of the years, REITs did not perform better than in all periods but still relatively better than US equities.

Historical returns of various asset classes split by different inflation levels



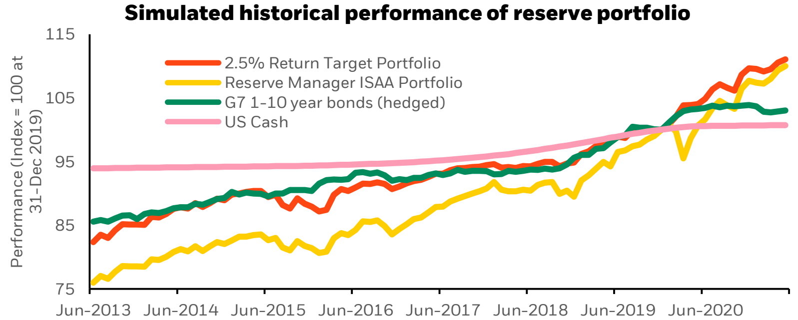
Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Source: Refinitiv - Datastream; as of 31-Mar-2021; All returns are in US dollars. 'US REITs' proxied by "FTSE EPRA Nareit United States REITs" index. 'US Equities' proxied by "MSCI USA" index. 'US Treasuries' proxied by "Bloomberg Barclays US Government Bond" index. 'US Corporates' proxied by "ICE BofA US Corporate" index. 'US HY' proxied by "Bloomberg Barclays US Corporate High Yield" index. 'US inflation' proxied by the "US Consumer Price – All Urban Items" index. Data from 31-Dec-1993 to 31-Dec-2020.

BlackRock Reserve Manager Model Portfolios Update

Our updated climate-aware capital market assumptions now more fully reflect the potential long-term implications of our new nominal investment theme that suggests nominal bond yields will likely be less sensitive to expectations for higher inflation than in the past. We still see government bonds playing a core role, especially short-dated treasuries, given the low risk levels and explicit need for liquid assets. This quarter we increased the allocation to inflation linked bonds and reduced exposure to DM equities. We keep real assets in the portfolio as we believe a small allocation preserves the liquidity of the portfolio and offers a diverse source of return. As seen to the right, the riskier compositions of the two 'model' portfolios led to a continued outperformance of these relative to the G7 Treasury benchmark.

Return focused reserve manager has a 2.5% volatility target. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** The 'Paper Portfolio' referred to is intended to provide only an example of the potential of the investment strategy to be employed and do not take into consideration actual trading conditions and transaction costs. The figures are for illustrative purposes only and results cannot be guaranteed. Source: Refinitiv Datastream; monthly data in USD from 31-Dec-2014 to 31-May-2021. It is not possible to invest directly in an Index. For illustrative purposes only. The chart shows the simulated hypothetical performance of two illustrative portfolios and two indices.

Simulated historical performance of reserve portfolio



	2.5% Return Target Portfolio	Reserve Manager ISAA Portfolio	G7 1-10 year bonds (hedged)	US Cash
2015	-1.1%	-0.8%	1.3%	0.2%
2016	3.6%	3.7%	2.0%	0.5%
2017	3.6%	7.6%	1.4%	1.1%
2018	0.5%	-1.4%	2.2%	2.0%
2019	5.4%	11.7%	4.6%	2.3%
2020	9.6%	7.7%	3.9%	0.7%
2021	1.3%	2.1%	-0.8%	0.1%

Official Institutions in the news

Sustainability

- Climate change and sustainability persist as top priority for official institutions, as they take action through both policy frameworks and investment decisions, as an increasing number of institutions are committing to sustainability goals.
- While industry initiatives such as the **Network for Greening the Financial System (NGFS)** is gaining traction in the central banking community and as highlighted by the recent Green Swan Conference co-sponsored day the **Bank for International Settlements, Bank of France**, **International Monetary Fund** and **NGFS,** institutions representing ~$70trn in assets have committed to net zero portfolio alignment. But there is still debate around how exactly to execute on that ambition, and ESG investing among the OI community must continue to accelerate to achieve net zero emissions.
- Two significant barriers to OI's climate change work are lack of data and common disclosure frameworks. Some central bankers believe climate disclosure requirements should be mandated in order to help the financial system transition to a net zero economy.

Investment Solutions

- Korea's **National Pension Service** is looking to implementing a negative screening approach as it seeks to boost its socially responsible holdings, and will no longer invest in companies that do not meet their standards. This plan comes as part of **NPS's** CEO's ambitious agenda on ESG investing, promising to make these principals central to their portfolio management.
- Sweden's **AP Funds** have cut fossil fuel exposure by SEK 11bn.
- OIs including **Norway's Government Pension Fund Global** are taking an active approach to green investing, with the announcement of its first investment in an unlisted renewable energy infrastructure project.
- The **Bank of Finland** and **European Central Bank** are investing in green bond funds that support renewable energy, energy efficiencies and the EU's overall climate goals, though some reserve managers face challenges when investing in green bonds because the asset does not necessarily 'fit' into their portfolios.
- Others are outlining their plans to construct greener portfolios, including the **United Nations Joint Staff Pension Fund's** promise to cut 40% of investments related greenhouse gas emissions by 2025. The **Asian Development Bank** has publicized plans to exit coal financing.
- Malaysia's **Employee's Provident Fund** is looking beyond short term performance and wants to integrate sustainability parameters into its key performance indicators, in addition to existing negative screening approaches.
- We explore here how reserve managers are turning to ETFs for ESG solutions.

Green Frameworks & Central Bank Policy

- **Bank Negara Malaysia** has released their climate change focused investment classification framework, which includes a system of transition categories and principles for assessing environmental outcomes of economic activity.
- **Monetary Authority of Singapore** has released a new climate-related disclosure framework that builds on its ongoing efforts to improve green finance activities. This framework includes **MAS'** efforts to work toward aligning climate-financial disclosures for financial institutions in Singapore with a single international standard.
- The **European Central Bank** has presented their action plan to include climate change considerations into monetary policy framework, operations, and macroeconomic modelling.
- The **European commission** has laid out their definitions on what will qualify as climate-aligned under their green taxonomy.
- For outsourced investments, OIs are looking to ensure that asset managers' standards and best practices concerning sustainability are aligned with their own. **New Zealand** is pushing forward a law requiring asset managers to report on the impact of climate change on their business.
- **Norway's Government Pension Fund Global** responds here to the Ministry of Finances' assessment on the fund's climate risk, and how climate-related investment opportunities can be addressed in the management of the fund, noting climate change is something that needs to be addressed by all investors.
- The **Bank of England** has published their climate stress-test scenarios, outlining an approach to assess how financial firms will cope with the transition to net zero.

The **Bank of England's** Executive Director of Markets Department Andrew Hauser gave a speech discussing that despite potential hurdles, central banks can use their monetary policy portfolios to support orderly transitions to net zero.

Hunt for yield

Portfolio Diversification

- Central banks are facing increasing pressure to find yield, turning to riskier assets such as equities, corporate bonds and emerging market debt to generate return in reserve portfolios.
- This comes as public pension and sovereign wealth funds are forecasting improved earnings for listed companies over the next year, with interest rate rises posing the greatest risk to financial market stability.
- Saudi Arabia's **Public Investment Fund** and Singapore's **Temasek** ramped up their US public equity portfolios in Q1 2021, focusing on stocks that are set to benefit most from the post-pandemic recovery as well as disruption caused by the crisis, particularly in tech-oriented sectors. **PIF** benefitted from a 21% increase in their US stock holdings in the first quarter.
- **Mubadala** is cutting holdings in energy and commodity-related assets and reallocating to 'disruptive' industries – including tech and healthcare.
- Korea's **National Pension Service** is pivoting to a 10-year asset allocation time horizon, and significantly increasing its exposure to riskier holdings. **NPS** and **Korea Investment Corporation** have been increasing holdings in the U.S. banking sector and semiconductor companies throughout the first quarter.
- In private markets, OIs are continuing to increase allocations to real assets. CIOs of **New Zealand Superannuation Fund** and **Thailand's Government Pension Fund** have indicated plans to increase infrastructure and real estate exposures; **Qatar Investment Authority** is planning to focus on warehouses and data centres.
- Despite COVID related uncertainties, sovereign wealth funds are set to continue increasing their focus on direct investments, after a record year for direct SWF investments in 2020.

Portfolio Returns

- As stock markets climbed higher, **Norway's Sovereign Wealth Fund** returned 4% in Q1 2021, but given record low interest rates and record-high stock markets, the fund's CEO sees these returns as unlikely to reproduce.
- **Bank of Israel**'s foreign reserves reached a record high in April, boosted by FX purchases and interventions aimed at preventing appreciation of the shekel's exchange rate.
- Crediting their public equities portfolio, **Mubadala** achieved record income in 2020, increasing overall assets by 4.8%.
- **Temasek** had a record year for both investment sales, posting a 24.5% one year return for the 12-month period ending 31 March 2021; **Monetary Authority of Singapore** has reported a 10% rate of return on their reserve portfolio, attributed to the strong global financial recovery during the fiscal year. .
- Also riding global equity gains, **Australia's Future Fund** returned 4.5% in Q1, posting their best YTD performance since 2017.
- Korea's **National Pensions Service** returned 9.58% in 2020, benefiting from the bull run in global markets and changes to their investment approach.
- Taiwan's **Bureau of Labour Funds** rebounded in the first four months of 2021 with a 6.07% return, compared to a loss of 6.9% in the same period in 2020.

People changes

APAC

- **Jin Seung-ho begins role as KIC CEO**
- **Li Bo announced as deputy governor of People's Bank of China**
- **Monetary Authority of Singapore's managing director appointed to a second term**
- **Mahesh Jumar Jain reappointed as deputy governor of Reserve Bank of India**

EMEA

- **Public Investment Fund appoints two new deputy governors**
- **UAE names new central bank governor**
- **Crown prince of Bahrain appointed as central bank deputy governor**
- **Oystein Borsum appointed deputy governor of Norges Bank**
- **Lithuania parliament approves new governor**

AMERs

- **Hazel Gonzalez named as deputy governor of Central Reserve Bank of El Salvador**
- **New governor takes office in Belize**
- **Mexican president names finance minister to head central bank**
- **Toru Shindo appointed as CIO for UN Pension Fund**

Top reads from around BlackRock

Portfolio Construction

Sizing china in strategic allocations

Strategic rivalry between the U.S. and China is creating a bipolar world. We believe investors need exposure to both spheres of growth to help meet their long-term goals.

China: The evolving investment landscape

China-focused experts examine the country's increasing economic and geopolitical influence and potential portfolio opportunities arising in the wake of China's dynamic growth. The emergence from the pandemic has been fast and strong; we believe the opportunity to access a dynamic market is growing.

Credit's next chapter

We see the pandemic—and the policy response to it—driving credit markets to create more options for companies seeking capital, and for investors seeking yield.. Additionally, China's efforts to restructure its credit markets should ultimately result in more productive companies and a healthier economy, in our view.

The new nominal: just getting started

Our strategic asset positioning tilts toward equities over credit and government bonds, even after the strong rebound we have seen since the equity market's lows of March 2020. We explore how the interplay between monetary and fiscal policy is informing our strategic investment views.

Investment Views

A New world of renewables

In confronting the challenges to mitigate global climate change, there is a fundamental mismatch between where investment needs to occur, and where capital currently resides. We assess the context, opportunities and priorities in emerging markets for renewable power investments.

Our outlook on commodities and ESG integration

Commodity prices benefitted from the global economic restart after the pandemic pause. Going forward, we believe ESG will be a core component of the investment process in commodities as both a risk and an opportunity.

Portable Alpha – putting portfolio capital to its highest and best use

In today's markets of low yields and lower expected returns, investors are looking for ways to increase overall portfolio performance while maintaining a diversified asset allocation. Portable alpha strategies can help investors seek both of these outcomes.

Is it too late to invest in healthcare and tech?

COVID 'winner' sectors like healthcare and tech have been challenged in recent months – have we reached the end of the road for strong performance in tech and healthcare sectors? Our BlackRock experts believe there is still room to grow, and our outlook on equities remains constructive relative to other asset classes.

Additional Insights

Geopolitical risk dashboard

We've relaunched our Geopolitical Risk Dashboard with a fresh set of risks as well as updated analytics for the market attention and movement of each risk.

Expanding our real assets toolkit

While the pandemic disrupted certain sectors of the real assets market, it also accelerated some major secular trends that are driving increased investment appetite across several key areas. We see the diversity of real asset tools as an underutilized advantage that will be key to outperformance going forward.

Alternative data – the information advantage in growth equity

Alternative data is changing the way we live, the way we work and now the way we invest. One of big data's biggest impacts is in private markets by applying predictive data sciences to chart a new path in alternative investing.

Sustainable Investing – integrating the UN SDGs with investments

BlackRock Sustainable Investing explores how the UN SDGs can be viewed through the lens of financial materiality and used for building strategies that seek to invest in the transition towards a more sustainable and equitable world.

For more, visit our dedicated **Official Institutions webpage** for latest insights and updates.

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