What a year 2020 was. We saw GDP changes in double digits, down, and then up, negative prices on oil futures, head-spinning stock price moves, a genuine policy revolution with central banks growing their balance sheets by as much in weeks as they did in years after the global financial crisis, eye-popping fiscal support packages, and blurred boundaries between the two as policy-makers strove to leave no one out of the safety net they deployed.

Fortunes made in highly successful tech IPOs and savvy stock market bets. But also tens of millions of jobs and livelihoods lost, over 100 million fallen into poverty and, over 1 850 000 lives lost. Tragic, and yet, compared to the 50 million lost in the 1917-18 Spanish flu evidence, that 2020 saw a triumph of human ingenuity, with technology that allowed millions to work and study safely and efficiently from home, and efficacious vaccines developed in a fraction of the usual time.

No doubt, huge challenges remain. But as 2021 begins, there is great momentum to tackle them, as well as pent up demand waiting to be unleashed, and a near-universal aspiration to rebuild better, and greener. On this hopeful note,

OIG wishes you a happy, healthy, and prosperous 2021.

Q4 in markets

Q4 has brought answers to big questions looming over 2020 – U.S. election results, COVID vaccine approvals, to name a few. These have brought about renewed confidence in near-term outlooks. Risk assets are set to end Q4 on a positive note, reflecting optimism that the end of the pandemic is near. Assets that lagged into Q3 generally outperformed, notably emerging markets, energy and European stocks. The USD$125.6b of inflows across asset classes in November smashed previous records set in January 2018, driven primarily by equity buying; this also November marked the largest monthly inflow to EM equities this year.1

That said, much positivity is now priced in, while resurgence of COVID cases across the U.S. and Europe, coupled with disappointing job data tells us we’re not in the clear yet, as reflected in persistently low interest rates.

1 BlackRock Global ETP Landscape, 30 November 2020

Are We Back (to pre–COVID growth?) Yet?

We are now optimistic that global activity should return to pre–COVID levels by next summer in the US and Europe, with a rebound pattern resembling that following a natural disaster rather than the GFC. But when will GDP return to trend?

A return to trend GDP means that the cumulative shortfall in activity caused by the COVID shock – which we see as the key driver of markets – would no longer be rising. As the U.S. and Europe continue to fight against case outbreaks and policy fatigue, the growth trend catch up point is pushed further out in time – current forecasts estimate this could take until 2025. By contrast, China is expected to return to pre–COVID growth trend by end–2020.

U.S. nominal GDP and projection, 2019–2025

Sources: BlackRock Investment Institute and Reuters, with data from Haver Analytics. December 2020. Notes: The green line shows actual nominal U.S. GDP in trillions of dollars. The yellow line shows the most bearish of the latest consensus GDP forecasts compiled by Reuters. The dotted orange line shows the pre-COVID growth trend. There is no guarantee that any forecasts made will come to pass.

Actual euro area GDP and growth estimates, 2019–2022

Sources: BlackRock Investment Institute, Eurostat, IMF and Refinitiv with data from Haver Analytics. Nov 2020. Notes: The green line shows the actual euro area GDP. The yellow line is the consensus forecast from April 2020. The orange line is our growth projection based on empirical work by the IMF and our estimate of euro area lockdown stringency based on announced measures. GDP is plotted as an index rebased to 100 in Q4 2019. There is no guarantee any forecasts made will come to pass.

What’s ahead

COVID has served as an accelerator of global trends. BlackRock Investment Institute (BII)’s key themes for 2021 include:

• The New Nominal: The hunt for yield will likely continue amid a higher inflation environment, with a positive trajectory for equities supported by falling real rates (more below).
• Globalization Rewired: A new world order in which tense U.S. – China relations trigger a reformation of global supply chains.
• Turbocharged Transformations: We see a continued growth in societal preference for sustainability.

Click here for more on our 2021 Global Outlook.
Investigating Inflation
One of BII’s most important strategic themes is that of a higher inflation regime, driven by joint fiscal-monetary policy revolutions and higher production costs, not least from expected realignment of global supply chains.

The charts below illustrate the risks of ignoring the impact of this new regime on asset prices. Specifically, they show our capital market assumptions and hypothetical 1-year US dollar unconstrained strategic asset allocation in two scenarios. In the first, higher inflation expectations feed into higher nominal yields, i.e., the historical playbook. In the second, higher inflation expectations feed through to lower nominal yields and more to lower real yields than the past, our current playbook.

The two scenarios have markedly different expected outcomes. Investors wishing to prepare their portfolios for higher inflation might need to do this differently than in the past, i.e. by holding more inflation-linked bonds and more equities, at the expense of holding less nominal government bonds.

Our December 2020 Portfolio Perspectives publication (A new playbook for higher inflation) discusses the above topic in more detail.

**Portfolio Implications of the current vs. historical inflation playbook**

Expected returns and hypothetical strategic 1-year USD allocation under different inflation scenarios, November 2020

<table>
<thead>
<tr>
<th>Allocation difference</th>
<th>Allocation difference</th>
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<tbody>
<tr>
<td><strong>Equities</strong> (2.5%)</td>
<td><strong>Private Equity</strong> (-2%)</td>
</tr>
<tr>
<td><strong>U.S. TIPS</strong> (1.5%)</td>
<td><strong>Emerging Bonds</strong> (-5%)</td>
</tr>
<tr>
<td><strong>U.S. govt bonds</strong> (4.0%)</td>
<td><strong>US Nominal Bonds</strong> (5%)</td>
</tr>
<tr>
<td><strong>Emerging market debt</strong> (6.0%)</td>
<td><strong>TIPS</strong> (10%)</td>
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<tr>
<td><strong>Historical playbook</strong></td>
<td><strong>Current playbook</strong></td>
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<td>0%</td>
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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, December 2020. Data as of 30 June 2020. The left chart shows our current CMAs (yellow bar) and hypothetical expected returns under a scenario of a pass through from higher inflation to nominal yields. The right chart shows hypothetical 1-year USD allocation to US. public assets under the two scenarios described. We use the macro assumptions and return estimates described hereto construct these hypothetical SAAs. For the left-most bar, there is no assumed rise in inflation expectations. It is not possible to invest directly in these indices. The hypothetical portfolio may differ from those in other jurisdictions, is intended for information purposes only and does not constitute investment advice. This estimate is illustrative only and does not take into account other factors such as the precise impact of inflation on individual equity sectors. The estimated drag on returns at the top end of the range is equivalent to our assessments of the alpha contributions of a top-quartile U.S. fixed-income manager as shown in our 2018 paper Blending alpha-seeking, factor and index investing: a new framework.

**Constructing a sustainability-aware portfolio**

In early 2021, BlackRock will, for the first time, release Capital Markets Assumptions that integrate sustainability. Underpinning them is our belief that 1) the transition to a low-carbon economy will have the potential of improving growth against a baseline of mounting climate damages in a "business as usual" world, and 2) that analysis of ESG factors can help estimate sustainability risk premia within and across asset classes. We focus on the "E" factor here and identify three channels through which sustainability premium is likely to arise: a macro channel, a repricing channel (driven by capital flows) and a fundamental channel (see chart). This sustainability premium will of course differ across geographies, sectors and issuers. For more on the sustainable capital market assumptions, click here to listen to our recent webcast.

**BlackRock Reserve Manager model portfolio**

Despite pivotal shifts in the market landscape, safety and liquidity remain core principles of reserve management. But what about return? Our 2020 Reserve Manager model portfolios make allocations beyond traditional reserve portfolio asset classes, including equities, EM, real assets and credit, with significant consideration on sustainability measures. Reserve management in an uncertain world takes a closer look at methodologies for constructing our 'Return Focused Reserve Manager' and 'Reserve Manager ISAA' portfolios. The allocation of the ISAA remained fairly unchanged; we increased our allocation to Chinese bonds marginally funded by sub-investment grade corporate bonds. 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 over the last three months. This outperformance was mainly due to a spectacular November. The performance dip we saw earlier this year has been fully recovered.

Return focused reserve manager has a 2.5% volatility target. The figures shown relate to simulated 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 30-Sept-2020. 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.
## Official Institution Trends

**Global round-up of OIs in the news**

### Hunt for yield

- Innovative portfolio construction and diversification is proving to be more important than ever for Official Institution portfolios; many reserve portfolios are adapting by **broadening investable asset classes beyond conservative fixed income.**
- After a buying spree at the onset of the pandemic, **large Middle East funds** may have to **rethink their strategies** as they are faced with falling oil prices and pandemic-related economic fallout.

### Sustainability

- **The tectonic shift is accelerating:** 56% of Official Institution respondents to BlackRock’s first **sustainable investing survey** have revealed that sustainability considerations are either top priority of considered very important to their investment approaches, and are planning to double their sustainable assets under management in the next five years.

### New drivers of return

- Official Institutions are showing no signs of curbing appetite for alternative investments and are capitalizing on pricing dislocations triggered by the pandemic.
- With a risk appetite that is notably larger than some OI peers, the **Qatar Investment Authority** has more than 50% of their portfolio invested in **public and private equities**, in an effort to seek higher returns; the **Bank of Israel** is including more volatile assets in reserves such as equities and investment grade corporate bonds, in pursuit of the same effort. For a **Baltic Central Bank**, despite COVID induced volatility they are **pleased with the performance of the equity allocation** in their portfolio and considering an increase to further diversify.
- Further demonstrating OI’s portfolio modernization, the World Gold Council reported that **Central Banks became net sellers of gold** in Q3’2020 for the first time since 2010.
- The **China Investment Corporation** is deploying capital into private markets to meet their goal of having 50% of assets in its global portfolio allocated to alternatives by 2022.
- **Abu Dhabi Investment Authority** has deployed USD$11bn+ in 2020 up +46% from last year’s spending, primarily into *private equity and co-investment vehicles*. Middle East sovereign funds including **Mubadala** and Qatar Investment Authority’s *appetite for direct lending opportunities* has driven the once-boutique dominated sector to an USD$850bn market.
- **GIC** believes there is **long term value in “undervalued” sectors** such as infrastructure, where valuations have taken a beating from the pandemic. **Taiwan’s Bureau of Labor Funds** is looking to deploy ~USD$4bn of assets across **global infrastructure and global multi-asset strategies**.
- To increase investment capacity in opportunities where New Zealand Super sees scalability, they are **building out capabilities in real assets**, while **Korea Investment Corporation** sees opportunity for returns in **U.S. real estate** amidst the pandemic.
- Despite hard hit valuations and challenged near-term outlooks due to pandemic-fall out, OIs see longer term growth opportunities in **emerging markets**. **ADIA** sees **India and China** as key drivers of global growth, and are looking to **opportunities in Africa** to generate investment returns. **Norway’s sovereign wealth fund** shows conviction in Turkey with nearly USD $800m invested in Turkey.

### Healthy returns

- **Asian reserve portfolios** tended to be more resilient during COVID market turmoil, attributed to low USD usage according to Central Banking Publication.
- Thanks to the 2020 market rally, **Korea Investment Corporation** expects to deliver a 10% rate of return.
- After a decline in Q3, **Bank of Israel’s reserves grew**; the bank holds a 15.1% allocation to equities.
- Through the end of September, the **Australian Government Future Fund** has suffered a -1.8% year-on-year decline, attributed to Q1 pandemic market selloff. However, after strong performance in Q3 the fund reached an +8.9% 10-year return.

### Incorporating sustainability in OI investments

- OIs are progressing with sustainability efforts through a range of policies and implementation measures; **70% of respondents** to Central Banking Publication’s Economics Benchmarks 2020 indicated that **climate change was an area of interest for their researches**.
- **Sweden’s AP1** has seeded a fossil fuel-free emerging markets **index fund**, with weighting based partially on sustainability performance.
- Following the pledge to exit investments from companies reliant on coal, **AP1** has screened fossil fuels from emerging market equity and global high yield portfolio investment universes.
- **Swiss National Bank** is reacting to climate calls by cutting coal firms from investments.
- **GIC** is evaluating long-term capital market assumptions under different climate scenarios, as part of a broader effort to integrate climate change considerations into all aspects of their investment processes.
- **Pertaining to real asset risk**, GIC is investigating potential impacts of climate on their real estate portfolio.
- **NZ Super** has noted their carbon exclusion approach has added return, while lowering overall portfolio risk; **Reserve Bank of New Zealand’s Adrian Orr** has commented in a recent speech on the institution’s “move to incorporate climate change as a key priority in activities”, supported by New Zealand’s move to become the first country to **require financial firms to declare climate-related risks**.
- Supply of sustainable investments has not quite caught up to demand; **Norway’s wealth fund** is **struggling to find private renewable energy projects** due to the paucity of projects, and high completion for stakes in them, as they look to **add ESG investments** to their portfolio to boost return.

### Taking action on climate risk

- In addition to considering sustainability through negative screening and investment in sustainable ventures, OIs are pushing forward the sustainability agenda with calls for global standards and risk assessments.
- **The Federal Reserve** along with seven other new members – including the central banks of **Paraguay** and **Uruguay** have joined the **Network for Greening the Financial Sector (NGFS)**.
- **Deutsche Bundesbank** governor Jens Weidmann supports disclosure-based policies and credit ratings considering climate risk measures.
- Climate change exists as a major focus topic for **APAC OIs**; **ASEAN Central Banks** have unanimously agreed to take action against climate and environmental portfolios; **NPS** and **GIC** along with other large asset owners have joined the Asia Investor Group on Climate Change; **Korea Investment Corporation** is now a member of the **One Planet Sovereign Wealth Fund Initiative**.

### People changes

**APAC**
- **Temasek names new Head of Sustainability**
- Liu Guiqing appointed vice-governor of PBoC
- **Future Fund confirms Sue Brake as new CIO**
- Vietnamese central bank gets first female governor
- **Reserve Bank of India has named a deputy governor**

**Americas**
- **Galicia Borja named as deputy governor of Bank of Mexico**
- Wilkins to leave Bank of Canada five months early
- **Colombia names new Central Bank governor**
- Robert Stennett appointed deputy governor of Bank of Jamaica

**Europe**
- Malta appoints finance minister as new governor
- Norway’s central bank deputy governor Jon Nicolaelsen resigns
- Sveriges Riksbank extends Henry Ohlsson’s term as deputy governor
- Signe Krogstrup named as a new member of the National Bank of Denmark’s governing board
- **Naci Ağbal appointed as governor of Turkish central bank**

**Middle East & Africa**
- **Lazard’s Mena head leaves to join PIF**
- **New Central Bank governor named in Iraq**
- **New Zambian governor appointed**

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As factor investing has grown in popularity in equity markets, investors wonder if a factor-based approach would apply in the fixed income markets. BlackRock research shows the core principle of factor investing – systematically identifying and capturing persistent risk premia – also applies to bond markets. Read more here.

Techniques aiming to deliver excess returns have evolved significantly over the course of the last decade. See how BlackRock’s Systematic Active Equity (SAE) platform has sought to capitalize on the changing landscape, and read more about new perspectives on macro investing here.

Despite the global health crisis caused by COVID-19, 2020 has been a positive year for market bulls. How can we assess the divergence between capital markets performance and macro fundamentals? Read our recent paper What’s Priced, and listen to our webcast discussion.

The outlook for protracted zero interest rate policy with historically low long-term interest rates means fixed income markets offer both lower returns and less equity diversification potential. Together, these pose unique challenges to the traditional 60/40 portfolio. More on this from our Systematic Fixed Income team here.

Just as many institutional investors have turned to ETFs to allocate capital, adjust positions, and manage risk during the environment onset by the COVID-19 pandemic, central bank reserve managers are also increasingly using ETFs to facilitate their policy goals. Listen here to a recent webcast BlackRock hosted on this topic, and read here a full report.
**Index Disclosures**

Index returns are for illustrative purposes only and do not represent any actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index.

<table>
<thead>
<tr>
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<tr>
<td>DM equities</td>
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<td>DM equities ex US</td>
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<td>EM equities</td>
<td>MSCI Emerging Markets</td>
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<td>ICE BofA 1–10 Year G7 Government Index (hedged)</td>
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<td>ICE BofA Global Inflation-Linked Government Index (hedged)</td>
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<td>ICE BofA US Mortgage Backed Securities Index</td>
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<tr>
<td>$–EMD</td>
<td>JP Morgan EMBI Global Index</td>
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<td>L–EMD</td>
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**Asset performance YTD indices**: MSCI EM Asia Index, MSCI AC Asia ex–Japan Index, MSCI USA Index, MSCI AC World Index, MSCI Japan Index, MSCI Europe Index, JPM EMBI Global Diversified Index, Bloomberg Barclays Global High Yield Index, JPM JACI Index, MSCI EM ex-Asia Index, Bloomberg Barclays U.S. Treasury; U.S. TIPS Index, JPM GBI-EM Global Diversified Composite Index, Bloomberg Barclays Global Credit –Corporate Index, TR German 10 year Bond Index, Bloomberg Barclays Global Aggregate Index, Bloomberg Barclays U.S. Treasury Index.

**Historical correlation chart indices** HFRI Global Hedge Fund Index aggregates managers across hedge fund strategies. The Barclays US Aggregate Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency). The CTA Index calculates the daily rate of return for a pool of CTAs selected from the larger managers that are open to new investment. Index returns are for illustrative purposes only. You cannot invest in an index. Long treasuries are 30+ year US government treasury bonds. *Diversification does not guarantee a profit or eliminate the potential for loss.*
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