Weekly commentary

BlackRock

Oct. 26, 2020

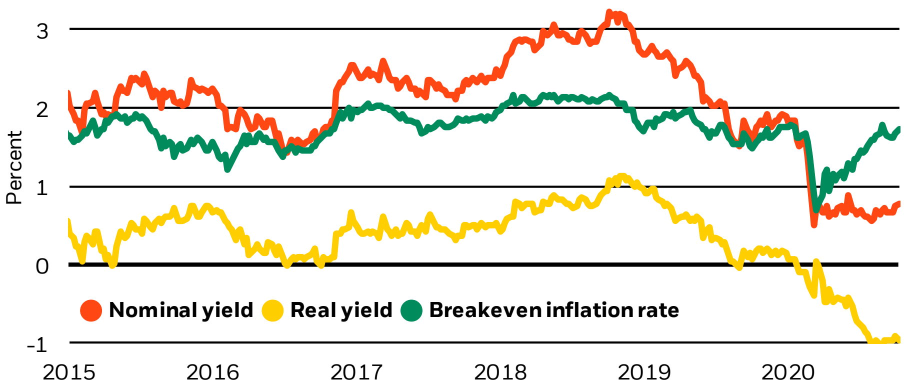
Changing our government bond views

- We downgrade U.S. Treasuries and upgrade their inflation-linked peers ahead of the U.S. election on a growing likelihood of significant fiscal expansion.
- A pickup in Covid-19 cases may weigh on mobility and activity in the near term, but we see this wave of infections as much shallower than the spring one.
- The European Central Bank's policy meeting this week will be in focus as markets expect potentially more monetary easing into 2021.

Markets are increasingly reflecting a unified Democratic government outcome that may lead to a significant fiscal expansion. This electoral outcome would bring forward the market pricing of the higher inflation regime that we were already reflecting in our strategic asset views. This is why, tactically, we are downgrading nominal U.S. Treasuries and upgrading their inflation-linked peers.

Chart of the week

U.S. 10-year nominal and real yields, breakeven inflation rate, 2017-2020



Sources: BlackRock Investment Institute and Refinitiv Datastream, data as of Oct.12, 2020. Notes: U.S. 10-year nominal yield refers to the 10-year Treasury yield. Real yield refers to the yield of 10-year Treasury Inflation-Protected Securities (TIPS). Breakeven inflation rate refers to the difference between the yields of a nominal bond and an inflation -linked bond of the same maturity – the 10-year maturity in this case.

Developed market (DM) government bond yields collapsed after the Covid shock and since appear to have found a bottom. The economic restart has been quicker than expected, even though the hardest part of the recovery lies ahead. Significant fiscal stimulus under a united Democratic government – an election scenario that markets are increasingly pricing in – could put upward pressure on Treasury yields. Yet the rise in yields would likely be limited as the Fed would act to prevent a sharp tightening in financial conditions, in our view. We already expected rising inflation over the next few years, as production costs rise and the Fed has pledged to allow inflation overshoots and let the labor market run hot. The monetary-fiscal policy revolution may also place greater political constraints on the Fed's ability to lean against inflation. We see the prospects of a unified Democratic government accelerating the market pricing of these dynamics. Breakeven inflation rates, a market-based measure of expected inflation, have rallied since March. See the green line in the chart. We see inflation-adjusted, or real yields, falling further, supporting prices of Treasury Inflation-Protected Securities (TIPS).

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We are upgrading German government bonds (bunds) to neutral, reflecting our greater caution on Europe's economic prospects. As Covid infections have picked up , the focus on further policy response has shifted to more monetary easing including additional asset purchases. Our views on bunds or U.S. Treasuries shouldn't be considered in isolation. We believe nominal DM government bond prices are headed lower, and expect bunds to have more modest price declines than U.S. Treasuries. Bunds are also likely to be less volatile, in our view, thanks to large-scale ECB asset purchases that have driven net issuance into negative territory, as well as the potential for further monetary policy support.

These latest changes in our tactical views align with our strategic views. We favor reduced exposure to nominal DM government bonds and greater allocations to inflation-linked bonds over a longer horizon, as interest rates remain near their lower bounds and inflation risks grow. We don't expect nominal bond yields to rise as much as the inflation backdrop might typically imply, as central banks keep rates low and allow temporary overshoots of their inflation targets. This environment could persist for some time, providing a favorable backdrop for risk assets.

The result of next week's U.S. election will further inform our tactical views. Democratic nominee and former Vice President Joe Biden has expanded his lead in national polls over President Donald Trump, and the likelihood of a Democratic sweep – winning the White House and the Senate – has risen. This outcome would have the most market impact as it would bring significant policy changes. The net difference in fiscal spending between a Democratic sweep and a Democratic presidency under divided government could be several percentage points of GDP over each of the next few years, we estimate.

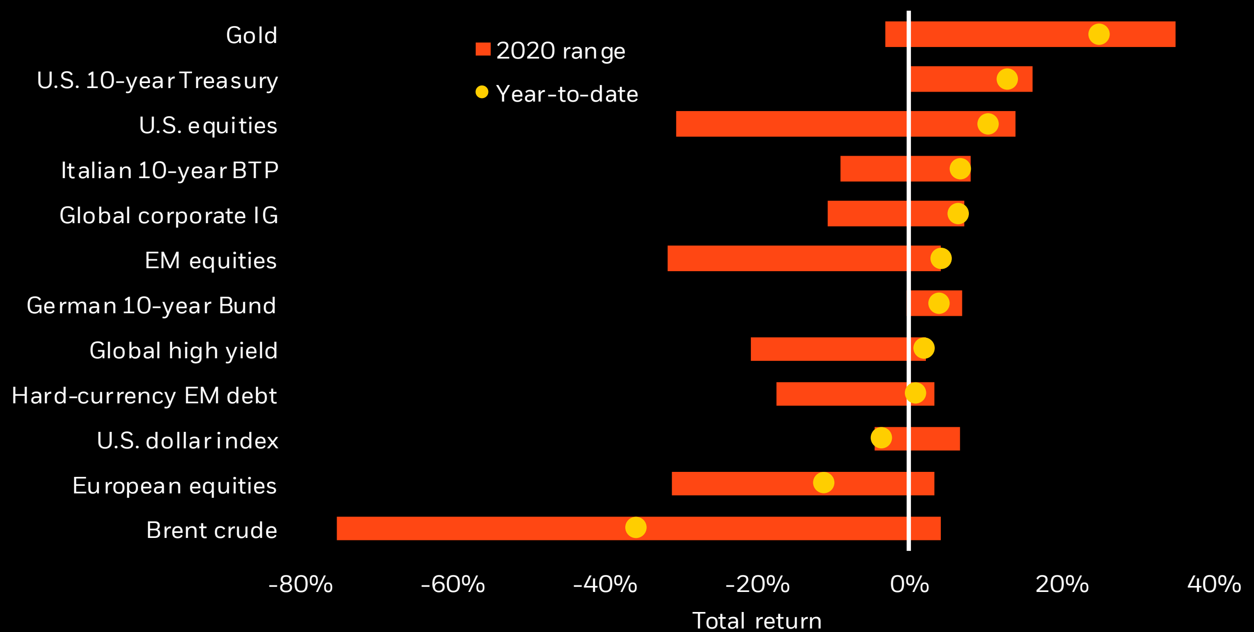
Bottom line: We are downgrading nominal U.S. Treasuries to underweight and upgrading TIPS to overweight due to the growing likelihood of a sizable fiscal expansion, with a Fed likely leaning against major yield increases. We have closed our underweight in German bunds, anticipating their outperformance over U.S. Treasuries. We keep the rest of our tactical asset views unchanged for now, such as an overweight in the quality style factor in equities. A Democratic sweep outcome in the election would tip us to a more pro-risk stance, with implications for many of our granular asset views. A risk to our view: An election outcome that diminishes the likelihood of significant fiscal stimulus.

Market backdrop

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

Assets in review

Selected asset performance, 2020 year-to-date and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2020. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot gold, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

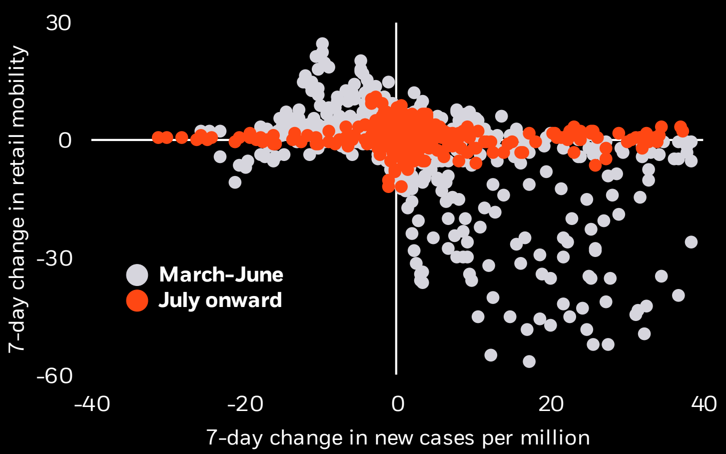
Macro insights

Covid-19 cases have surged in the U.S. and Europe, yet we don't see this as a replay of March and April. Why? The current wave has been significantly smaller and slower than the first wave after correcting for the greatly increased volume of testing. In addition there appears to be less of a trade-off between economic activity and public health. Our base case remains a shallower, longer second wave that is unlikely to have the same impact on mobility as the initial outbreak. Yet the hardest part of the restart – closing the gap to pre-Covid activity levels – lies ahead.

In the first three months of the pandemic, mobility plunged due to strict government lockdowns. Voluntary social distancing also played a role, according to the International Monetary Fund (IMF). Since June, rising cases have not had a major impact on mobility. See the chart. The absence of national government lockdowns is a key reason. The weakening relationship also suggests that measures such as mask-wearing, capacity limits and self-shielding allow a large share of activity to continue as cases rise.

Diminishing impact

Change in Covid-19 cases and retail mobility for G7 countries



Sources: BlackRock Investment Institute, Google and Our World in Data, Oct 2020. Notes: The chart shows the seven-day change in new Covid-19 cases per million people in G7 countries and the seven day change in retail and recreation mobility.

Investment themes

1 Activity restart

- The activity restart is moving into a more difficult phase just as a flare-up of coronavirus infections prompts tighter restrictions. The initial phase of the economic restart has been quicker than expected, as reflected by the IMF's recent upgrade to its global growth outlook. We see the hardest part lying ahead.
- Covid infections have picked up, but fatalities and hospitalizations have risen only moderately. We see the current wave as smaller and shallower than the first wave, after correcting for more testing. Rising case counts are having a diminishing negative impact on mobility.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-Covid world could be painful, especially for contact-intensive sectors if mobility is curtailed for an extended period of time.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both a strategic and tactical horizon. We have a preference for cyclical assets in Europe.

2 Policy revolution

- The joint fiscal-monetary coordination in response to the Covid-19 shock is nothing short of a policy revolution. The Federal Reserve is leading major central banks in evolving policy frameworks to explicitly aim to let inflation overshoot targets – a desirable move in the current environment but the lack of proper guardrails raise concerns.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus. The window for a pre-election deal is rapidly narrowing, raising the risk of no additional fiscal stimulus until a new Congress is seated in early 2021. We also see a need for the European Central Bank to step up its relief programs to help cushion the euro area economy.
- Europe's historic recovery fund will introduce mutualized debt and create jointly issued European bonds that can compete with other perceived safe-haven assets. It still needs approvals by the European and national parliaments.
- The blurring of monetary and fiscal policy means that it is crucial to have proper guardrails around policy coordination. In their absence we see a risk that major central banks could lose grip of inflation expectations relative to their target levels. Combined with other structural changes accelerated by Covid such as deglobalization, it could lead to a higher inflation regime in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on both strategic and tactical horizons. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions in technology stocks.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We see countries, sectors and companies making a comeback as potential diversifiers in a fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. We believe investors should consider alternative return sources that can provide potential diversification.
- A focus on sustainability makes portfolios more resilient, in our view. We believe the adoption of sustainable investing is a tectonic shift carrying a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer sustainable assets, private markets and deliberate country diversification on a strategic basis. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops, and generally prefer developed markets over the emerging world.

Week ahead

Oct. 26	Germany ifo Business Climate Index; U.S. new home sales	**Oct. 29**	ECB policy meeting; U.S. advance third-quarter GDP; German preliminary consumer price index
Oct. 27	U.S. Consumer Confidence Index	**Oct. 30**	Preliminary third-quarter GDP for Germany, Spain, France and Italy

The ECB policy meeting will be in focus. We expect the central bank to announce further monetary easing before the end of the year in order to fend off a further undershoot of its inflation objective. A string of data from Europe this week could shed light on the pace of the recovery, as Covid infections rise again in the region and threaten to derail the economic restart.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 2020

Asset	Strategic view	Tactical view	
Equities	Neutral	Neutral	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall. We like the quality factor for its resilience and favor Europe among cyclical exposures.
Credit	Neutral	+1	We are neutral on credit on a strategic basis because we see investment grade (IG) spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, we strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
Govt bonds	-1	Neutral	The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. Such low rates reduce the asset class's ability to act as ballast against equity market selloffs. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation suppresses yields.
Cash		Neutral	We are neutral on cash. Holding some cash makes sense, in our view, as a buffer against supply shocks that could drive both stocks and bonds lower.
Private markets	Neutral		Non-traditional return streams, including private credit, have the potential to add value and diversification. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures but valuations and inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, October 2020. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Change in view

Previous New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, October 2020

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. Risks of fading fiscal stimulus and an extended epidemic are threatening to derail the market's strong run. Renewed U.S.-China tensions and a divisive election also weigh.
Equities	Euro area		■	We are overweight European equities. The region is exposed to a cyclical upside as the economy restarts, against a backdrop of solid public health measures and a galvanizing policy response.
Equities	Japan			We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
Equities	Emerging markets	■		We are underweight emerging market equities. We are concerned about the pandemic's spread and see less room or willingness for policy measures to cushion the impact in many – but not all – countries.
Equities	Asia ex-Japan			We hold Asia ex-Japan equities at neutral. Renewed U.S.-China tension is a risk. China's goal to balance growth with financial stability has led to relatively muted policy measures to cushion the virus fallout.
Equities	Momentum			We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold.
Equities	Value			We are neutral on value. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance.
Equities	Minimum volatility			We hold min vol at neutral. The restart of economies may benefit cyclical assets and reduce the need for defensive exposures.
Equities	Quality		■ ■	We keep our strong overweight on quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy.
Fixed Income	U.S. Treasuries	■		We downgrade U.S. Treasuries to underweight. The potential for fiscal spending – particularly in a Democratic sweep election outcome – could spur higher yields and a steeper yield curve.
Fixed Income	Treasury Inflation-Protected Securities		■	We upgrade TIPS to overweight. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy, greater fiscal stimulus and increasing production costs.
Fixed Income	German bunds			We upgrade bunds to neutral. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
Fixed Income	Euro area peripherals		■	We are overweight euro area peripheral government bonds despite recent outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions.
Fixed Income	Global investment grade			We hold investment grade credit at neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
Fixed Income	Global high yield		■ ■	We keep our strong overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
Fixed Income	Emerging market – hard currency	■		We are underweight hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced.
Fixed Income	Emerging market – local currency	■		We are still underweight local-currency EM debt. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
Fixed Income	Asia fixed income			We are neutral on Asia fixed income. The pandemic's containment in many countries and low energy exposure are positives. Renewed U.S.-China tensions and China's relatively muted policy fallout are risks.

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