Summer is here: Making lemonade out of lemons

The great poet Ralph Waldo Emerson famously wrote, “Do what we can, summer will have its flies.” As we head into the summer months, this mood may best describe nervous investors who recently experienced large bouts of market volatility due to the spread of the coronavirus. The S&P 500 Index fell 34% from its all-time high reached on February 19 to its low on March 23.1 While it has recovered since then, we are seeing global economic activity reflects the implementation of mandatory "shelter-in-place" policies. Simultaneously, extreme moves in the oil market — with West Texas Intermediate (WTI) oil futures prices at one point trading in negative territory due to fears of oversupply — caused additional distress in markets.

Globally, central banks and governments stepped up to provide unprecedented levels of stimulus measures on both the monetary policy and fiscal fronts. At BlackRock, we see three investment implications from this stimulus. First, we would like to maintain core benchmark holdings and rebalance selectively into risk assets such as credits. Second, we see coupon income as critical in a low-yield world and prefer allocations to corporate credit and even select equity industries. Finally, we would maintain resilient portfolios by focusing on U.S. equities and diversifying perceived safe havens, such as U.S. Treasuries.

Investor risk sentiment began to improve in line with reduced market volatility as a result of policy actions. We see evidence in the high level of dispersion at the industry and country levels as investors refocus on the idiosyncratic stories of each area. Interestingly, megatrends also remain in focus, with infrastructure being one area that is arising frequently in client discussions as a contender for further stimulus measures, especially given its high fiscal multiplier effect and the broad bipartisan support it enjoys.

Meanwhile, our view on momentum has decidedly improved this quarter while we remain underweight size due to an unfavorable economic regime and recent trends. Although recent headlines have warned of a looming global recession, our regime indicator remains in slowdown and we’d need to see growth closer toward zero in order to move to contraction. We are neutral on minimum volatility, quality and value.

So, while summer may have its flies, this edition of Investment Directions can be used as a fly swatter (both figuratively and literally) to help our clients navigate markets in the upcoming months.

1 Source: Bloomberg, as of April 30, 2020.
U.S. equities

Key takeaways

• **We are constructive on U.S. equities** thanks to a sizeable policy response and relative quality bias supporting resilient earnings growth. An elevated equity risk premium underscores our long-term preference for core U.S. equity exposure.

• **We favor rebalancing into risk assets.** Core U.S. equity exposure should play a crucial role going forward and elevated risk premiums portend well for strong long-term returns.

• **Industry dispersion is likely to stay elevated** — investors who take a granular approach below the sector level may find idiosyncratic opportunities and exposure to secular, long-term growth trends.

Market pulse

Global markets have taken a beating. March witnessed the fastest bear market on record as funding market stress led to margin calls, deleveraging, forced selling and air pockets of illiquidity that exacerbated market volatility — until the Federal Reserve stepped in. The Federal Reserve acted decisively with a range of policy measures, both new and old, in a “whatever it takes” moment to backstop funding and market liquidity, ensure free flow of credit to Main Street and effectively implement a form of yield curve control — through its unlimited quantitative easing (QE) pledge — to help finance fiscal stimulus measures that were also announced.

The cumulative effect of a large rally in Treasuries and sell-off in equities had a twofold effect: First, a 60/40 stock/bond portfolio may have materially drifted from its target asset allocation weights. Second, the equity risk premium — the compensation that investors require to hold equities over risk-free assets — has sharply increased. As a result, we favor rebalancing into core U.S. equity exposure amid attractive valuations.

A key reason behind our enthusiasm to re-risk into U.S. equities is their bias toward quality — low leverage, high return on equity, clean balance sheets — which offers a more defensive posture within global equities. We also believe precision exposures can complement core positions and reiterate our preference for tech and healthcare, specifically software and healthcare providers. Both industries have strong quality features with durable industry trends to support them as cyclical growth potentially weakens.

**Figure 1: Equity risk premiums offer fair compensation for risk-taking**

Source: Refinitiv, as of April 30, 2020. Notes: The equity risk premium measures the ex-ante compensation for risk-taking in equities in excess of a risk-free total return. It is measured as the S&P 500’s 12-month forward earnings yield less the real bond yield. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.
A tale of flows

Evidence of an economic slowdown is one reason cyclicals continue to see strong outflow pressure with industrials, consumer discretionary and financials leading global ETP outflows. Investor de-risking can be seen in the relative shift away from these three cyclical segments and into defensive areas like consumer staples, utilities and healthcare. Note that consumer staples and utilities saw the past year’s inflow streak continue over the past three months — however, we would highlight the growing healthcare inflows that indicate newfound interest in the space.²

It may be surprising to see energy leading global equity ETP flows. However, there is plenty of evidence that suggests the bulk of energy inflows are related to “create-to-lend” activity. As oil and equity markets crashed, the demand for short energy rose as evidenced by the rising short interest and cost to borrow of energy ETPs. To meet the increased short demand, authorized participants can create new shares of the ETP, which are then loaned out to the short community by the long holders. With oil hitting rock bottom, and even negative on front-month benchmark West Texas Intermediate (WTI) prices, if the appetite to bet against energy wanes in the coming months, then we would expect an unwind in the energy space that could lead to more energy ETP outflows.

Figure 2: Creating-to-lend drives global energy ETP flows

![Figure 2: Creating-to-lend drives global energy ETP flows]

Source: BlackRock, as of April 30, 2020.

If the 3-month flow figure is larger than the 12-month flow figure, then we know flows in the first 9 months of the 12-month figure must have been negative.
International equities

Key takeaways

- **International investing has been helped by the high differentiation across countries**, reflecting the progress of responding to the coronavirus impact.
- **BlackRock is constructive on Asia ex-Japan equities on the prospect of an eventual growth uptick there.** In particular, China and South Korea are in the early stages of restarting their economies and potentially have a greater ability to use policy in order to reboot economic activity.
- **Overall, BlackRock holds a neutral rating on emerging market (EM) equities.** Valuations have cheapened but the global economic slowdown and cheaper oil could challenge oil-producing EM economies. Further, the outbreak may test their public health systems.

Market pulse

The COVID-19 outbreak and its economic toll have driven unprecedented levels of financial market volatility in 2020, with global equities plunging -21.3% in the first quarter of the year. The challenging global environment led to heightened market differentiation across international economies as investors paid close attention to the differences in economic fundamentals, fiscal conditions and the quality of public health systems.

Since Asia was the earliest region affected by the coronavirus, aggressive public health measures to contain the pandemic have slowed its spread — indeed, the infection curve for many Asian countries has shown signs of flattening. The region also benefits from high quality balance sheets and from lower oil prices as most Asian nations are net oil importers.

Strong monetary and fiscal easing measures have supported domestic Chinese companies, as the People’s Bank of China (PBOC) cut interest rates in March with additional fiscal stimulus to support small and medium enterprises. The recent drop in oil prices and low inflation give the PBOC more room to ease policy from already accommodative levels. The combination of an improving coronavirus infection curve along with the strong policy response is a key reason investors allocating to China have been rewarded. Indeed, Chinese equities have outperformed global equities by nearly 10% year-to-date (YTD) (Figure 3).

**Figure 3: Chinese equities have outperformed amid coronavirus containment**

Source: Thomson Reuters, as of April 30, 2020. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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Overview

High differentiation in government policy response to the coronavirus impact speaks to the importance of expressing views with single country international exposures.

CONSIDER

- iShares MSCI China A ETF (CNYA)
- iShares MSCI China ETF (MCHI)
- iShares MSCI South Korea ETF (EWY)
- Core MSCI Emerging Markets ETF (IEMG)

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3 Bloomberg, as of March 31, 2020, based on the MSCI AWCI Index.
4 Worldometers, as of April 20, 2020.
5 Thomson Reuters, as of April 30, 2020.
A tale of flows

ETP data reveals that U.S. investors have been selective in their country preferences when allocating internationally. While U.S.-listed ETPs with broader emerging market exposures registered outflows of $5 billion over COVID-19 concerns, single-country EM equity ETPs into exposures such as China and South Korea have gathered inflows over this period. This indicates that investors are using single countries to express selective views based on their perception of resilience to virus spread, and oil importers versus exporters.6

Interestingly, while Chinese-focused ETPs saw massive outflows in February due to the impact of COVID-19, the trend quickly reversed with consecutive weekly inflows into China-focused, U.S.-listed ETPs in March, bringing year-to-date total inflows to more than $1.5 billion as of April end (Figure 4).

Figure 4: EM Asia flows YTD

![Figure 4: EM Asia flows YTD](image)

Source: Markit, as of April 30, 2020. Flows are subject to change.

6 Markit, as of April 30, 2020.
Megatrends in focus

Key takeaways

- Investors considering infrastructure as an investment theme may benefit from renewed appetite by governments globally to address this gap, though it is critical to understand the various global and regional drivers at the global, U.S. and emerging markets levels.
- Infrastructure is an important component of economic growth and integral to the functioning of modern society, spanning transportation, commodities and data. However, despite its importance, global infrastructure spending is lower than what is required for current population growth rates.
- Governments globally may use infrastructure investment as a method of fiscal stimulus to counter the negative economic consequences of the coronavirus, providing short-term employment opportunities coupled with long-term productivity gains.

Market pulse

Infrastructure is characterized by long-lived real assets with useful lives typically greater than 20 years. While this asset class has been long known to investors, infrastructure has recently emerged as a key discussion topic. This is because its defining characteristics — stable free cash flows, high dividends and beneficiary of much-needed government spending — appeal to investors given the current environment of slowing economic growth.

We observe three drivers that could support the trend in both the short and longer term. First, valuations are attractive. For example, year-to-date through April 30, global infrastructure underperformed its benchmark, the MSCI ACWI index, by 9.2 percentage points while U.S. infrastructure underperformed the S&P 500 index by 11.3 percentage points. Second, there is a global need for infrastructure. A report penned by the McKinsey Global Institute in 2019 estimated that the world needs to invest approximately $3.7 trillion per year on average through 2035 into roads, railways, ports, airports, power, water and telecom. China is likely to be a leader in this regard: Oxford Economics estimates China will represent an anticipated 30% of global spend between 2016 and 2040. Third, bipartisan support may make it easier for the United States, in particular, to boost U.S. infrastructure spending either with government-led projects or through public-private partnerships. Legislators are expected to debate this issue in second quarter 2020 as the next round of fiscal stimulus talks gets underway and it is likely to become a key talking point headed into the U.S. elections in November.
Figure 5: Infrastructure across U.S., EM and Global has underperformed YTD

Source: Bloomberg, as of April 30, 2020; Indexes used include first chart: NYSE FactSet U.S. Infrastructure Index, S&P 500 Index; second chart: S&P Global Infrastructure Net Total Return Index, MSCI ACWI Index; and third chart: S&P Emerging Markets Infrastructure Net Total Return Index, MSCI Emerging Markets Index. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

A tale of flows

Over the previous four years (2016-2019), infrastructure-related ETP AUMs increased 188%, or $4 billion. Year-to-date as of April 30, infrastructure ETPs have seen inflows of nearly $400 million, representing ~7% of funds’ AUM, or nearly $400 million. Note that the majority of U.S.-listed ETP flows have been directed into global infrastructure funds — which hold 99% of total ETP infrastructure assets under management — rather than U.S. and emerging market infrastructure funds.

Figure 6: Flows into U.S.-listed Infrastructure ETPs YTD

Source: Markit, as of April 30, 2020. Flows are subject to change.
Fixed Income
Stabilizing liquidity: Opportunities in credit markets

Key takeaways
• Bond market liquidity has begun to stabilize from the depths of the market sell-off that began in February and continued through late March. Extraordinary measures taken by global central banks, including purchases of corporate debt, have increased liquidity and reduced systemic risk.
• While credit spreads have retraced somewhat from their March highs, credit risk nonetheless remains elevated as we transition from liquidity risk to solvency risk. However, we do recommend a modest overweight to high grade credit given the stabilization of liquidity and the favorable yield profile relative to Treasuries.
• Fixed income ETP flows were dominated by a flight-to-quality to government bonds — particularly shorter-duration bonds. However, investors began to return to investment grade and high yield corporate bonds toward the end of March.

Market pulse: Bond markets recovered but uncertainty abounds
Bond markets saw extreme levels of volatility in February and March as investors reacted to the economic impact of the COVID-19 crisis. Even U.S. Treasuries experienced reduced liquidity, widening bid-ask spreads and price dispersion. Investors sold $118 billion of prime money market funds and $175 billion of U.S. taxable bond funds in the first quarter in an effort to raise cash. This was by far the largest amount of bond fund redemptions in a quarter on record. Motivated sellers rapidly forced bond prices lower, resulting in a massive amount of spread widening. Investment grade corporate spreads widened from below 1 percentage point before the sell-off began on February 19 to a peak of nearly 3.75 percentage points on March 23.11

Sentiment shifted in late March with news of global central bank and fiscal stimulus programs arriving. Bond market liquidity has now stabilized, but uncertainty abounds about solvency in this environment. Estimates of downgraded bonds range from 3% to 5% of the investment grade universe and high yield defaults have already increased to 3.3%. Estimating high yield defaults range from roughly 10% to 15%. Issuers may seek to repay existing debt by cutting dividends and issuing more debt. The U.S. investment grade primary market experienced a surge of issuance in March. More than $600 billion of new bonds, an 80% increase year-over-year, have been issued YTD as corporations build cash reserves and shore up liquidity.14

Credit spreads are reflecting the uncertainty in the economic outlook, but investors seeking to boost total return in bond portfolios can seek more attractive yield levels. As of April 15, 2020, U.S. investment grade bonds are yielding just under 3% and high yield bonds are yielding under 8%.15

Overview
We see opportunities in credit markets. Extraordinary measures by central banks — including purchases of corporate debt — provide a favorable backdrop.

CONSIDER
• iShares Broad USD Investment Grade Corporate Bond ETF (USIG)
• iShares Broad USD High Yield Corporate Bond ETF (USHY)
• iShares Fallen Angels USD Bond ETF (FALN)
• iShares U.S. Treasury Bond ETF (GOVT)
• iShares National Muni Bond ETF (MUB)

10 Investment Company Institute, as of April 30, 2020.
11 Source: Bloomberg Barclays US Corporate Bond Index.
12 J.P. Morgan, as of March 31, 2020.
13 Source: estimates are from BlackRock and JP Morgan, as of April 30, 2020.
14 Source: Blackrock, as of April 30, 2020.
15 Bloomberg Barclays US Investment Grade Bond Index and Bloomberg Barclays US Investment Grade Bond Index yield to worst, as of April 15, 2020.
Figure 7: Credit spreads have tightened with plenty of room to normalize further

Credit spread (%)

Source: Investment grade is represented in the Bloomberg Barclays US Investment Grade Bond Index and High yield is represented by the Bloomberg Barclays US Investment Grade Bond Index option adjusted spread past 5 years ending April 30, 2020.

A tale of flows: Government bonds still reign

Fixed income ETP flows were dominated by the flight-to-quality in government bonds. U.S. Treasury bond ETPs gathered $26 billion year-to-date, primarily into T-bill ETPs as investors moved to boost cash and shore up liquidity. MBS ETPs also saw positive inflows of $1.4 billion. After the bond market stabilized in late March, investment grade credit saw positive inflows of $7 billion.\(^{16}\)

Additionally, some investors rebalanced target allocations back to equities and sold out of core bond and multi-sector bond ETPs. With the collapse in oil prices, investors moved out of emerging market debt and Treasury Inflation-Protected Securities (TIPS). Interestingly, while $4 billion was redeemed from inflation-linked bond ETPs, TIPS continued to serve as an equity market diversifier, returning 4.5% YTD through April 30 due to rapidly falling real yields.\(^{17}\)

Figure 8: U.S. listed bond ETP flows by sector

ETF Flows ($ mm)

Source: BlackRock, year-to-date flows through April 30, 2020.

\(^{16}\) Source: Bloomberg and BlackRock, as of April 30, 2020.

\(^{17}\) Source: Bloomberg, performance based on the total returns of the Bloomberg Barclays TIPS Index, as of April 30, 2020.
Q2 factor outlook

Outlook views

• **Moderate overweight on momentum.** Our outlook on momentum has improved from a moderate underweight previously. The factor’s relative strength has sharply improved and now appears more attractive. Cash flow-based valuations have also modestly cheapened, although valuations overall continue to appear expensive relative to other factors.

• **Underweight on size.** Our outlook remains underweight for the size factor as its relative strength has deteriorated and remains quite depressed compared to other factors. Valuations, however, continue to appear cheap, particularly with forward-looking measures.

• We remain neutral on minimum volatility, value and quality.

And then the world changed...

Because factors are driven by different economic rationales, they historically have tended to outperform in different market environments. Our economic regime indicator is a key input to our factor tilting model and has remained in a slowdown regime since April 2018. With headlines warning of a global economic contraction due to coronavirus, we are monitoring our indicator for any further deterioration into contraction territory.

As seen in the **Navigating growth** chart, BlackRock Investment Institute’s Growth GPS — which feeds our economic regime indicator — declined in March as the impact of social distancing policies started to weigh on economic activity. However, it remains at a solid overall level of 1.8% for the United States as of March 31, which confirms the current slowdown regime and guides our factor positioning today.

Figure 9: Navigating growth
BlackRock’s Growth GPS for the U.S. and G7

Rather than attempt to predict where the economic regime will be in the future, which is a difficult feat, our model calibrates positions based on where the data suggests we are today. While we expect the subsequent data will show the large expected disruption in growth, there can be a fair bit of disorder as the market settles from slowdown to contraction. In other words, we don’t have much to gain from extrapolating the data into the future and positioning for contraction before the data suggests, even if we are certain that is where the data will end up in a few months’ time. In essence, this is what it means to be a quantitative investor; instead of predicting trends into the future based on qualitative insights or intuition, we depend on the robustness of our systematic models in evaluating all available data today. In order for our regime model to move into contraction, we would need to see the Growth GPS data closer toward 0%.
Notes from the field – rebalance your core

The economic slowdown — and resulting market sell-off — has had a marked impact on portfolios. BlackRock’s portfolio solutions team has noted that moderate 60/40 stock/bond portfolios became 50/50 ones very quickly in the first quarter. When moments like this happen, the core of the portfolio becomes weakened, hampering recovery. As a result, we see rebalancing as an essential practice. The global financial crisis offers an interesting case study on the necessity of rebalancing. A 60/40 portfolio of global stocks and bonds peaked in October 2007 and eventually drifted to contain only 38% in equities at the market bottom 18 months later. Then, with the recovery nine months underway, the un-rebalanced portfolio only reverted back to a 50% weighting in stocks by December 2009 and didn’t reach 60% in stocks again until August 2017!

We believe that investors should consider the following things when assessing their portfolios: they may want to reset the portfolio by rebalancing back to the basic asset allocation, based on their individual risk and return profile. If they are bullish, they could position for a rebound, by taking advantage of the buying opportunities presented by the recent market selloff. Investors could also redesign the strategic positioning of their portfolios, with rates near zero, sector dispersion widening and inflation possibly on the radar for the first time in over a decade. All three pathways have merit, and all start with a focus on the core of the portfolio. The key is that asset allocation is an active process. We see this as a key hurdle — and opportunity — for investors.

Let us know …

How do you use this market commentary, and do you find it useful? Please share your feedback and any questions or concerns you have at GroupiSharesInvestmentStrategy@blackrock.com.

You also can find the latest market commentary from the ETF Investment Strategies & Insights group at iShares.com/insights.

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Underweight: Potentially decrease allocation
Neutral: Consider benchmark allocation
Overweight: Potentially increase allocation

18 Note: 60/40 is a portfolio consisting of 60% equities and 40% bonds, which is often used as a representative allocation for long term investing. We use the MSCI World Index and Bloomberg Barclays Global Aggregate Bond Index to represent the two asset classes.
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