

Weekly commentary

Dec. 7, 2020

BlackRock

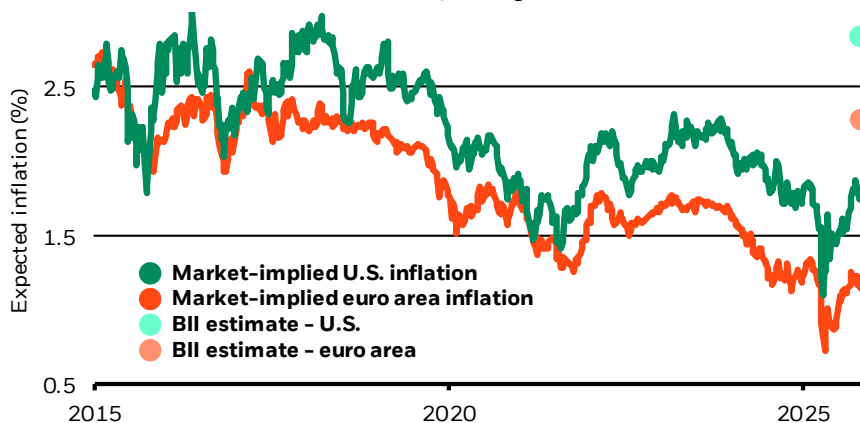
Why we are turning bullish for 2021

- We are pro-risk for reasons beyond an expected vaccine-led upswing. We see low nominal rates – even in the face of rising inflation – helping risk assets.
- Global stocks hit record highs amid positive vaccine news and hopes for a U.S. fiscal package, even as near-term challenges weighed.
- The European Central Bank (ECB) is expected to announce further monetary easing after its policy meeting this week.

The expected widespread rollout of Covid-19 vaccines in 2021 has strengthened our conviction in an accelerated economic restart. We have turned more pro-risk, upgrading equities to a tactical overweight. This pro-risk stance is becoming consensus, but the rest of our views are much less so. Among them: a “new nominal” in which nominal yields are likely to stay capped even as inflation rises.

Chart of the week

U.S. and euro area inflation market pricing vs. our estimates, 2015-2020



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute and the Federal Reserve with data from Refinitiv Datastream, November 2020. Notes: The chart shows market pricing of expected average inflation over the coming five-year period. We use the five-year/five-year inflation swap which is a measure of market expectation of inflation over five years, starting in five years' time. The lines are shifted forward five years. The orange and green dots show our current estimates of average U.S. CPI and euro area inflation for the same five-year period of 2025-2030.

Higher inflation associated with the expansion phase of past economic cycles was typically bearish for risk assets. It often led to higher interest rates that pressured valuations across many asset classes. Yet the traditional business cycle playbook does not apply to the pandemic, in our view. We see the shock as more akin to that of a large-scale natural disaster followed by swift economic restart. Expectations for a broad rollout of Covid vaccines have boosted the case for the restart to gather pace next year, boding well for risk assets. We see higher inflation in coming years and the policy revolution implies that central banks will limit the rise of nominal yields. Even the moderate rise in inflation that we expect may surprise markets, as the chart above suggests. Yet we see this as a positive backdrop for equities: Firmer inflation and a lid on nominal yields mean lower real interest rates. This supports equity valuations: the present value of future cash flows is higher when discount rates are low.



Jean Boivin
Head – BlackRock Investment Institute



Elga Bartsch
Head of Macro Research – BlackRock Investment Institute



Mike Pyle
Global Chief Investment Strategist – BlackRock Investment Institute



Scott Thiel
Chief Fixed Income Strategist – BlackRock Investment Institute

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Our pro-risk view is fast becoming consensus, and could be quickly priced in. But we see our views departing from the crowd in three key ways: First, many are still looking ahead to 2021 through the lens of a traditional business cycle framework. But we believe this playbook doesn't apply: in the same way that the "stoppage" was different from a "recession", the "restart" is different from a "recovery." This is not a story about a broad-based cyclical recovery. Instead, the story is a sectoral one: an uneven rebound across sectors combined with *Turbocharged transformations* – one of our three new investment themes. This is why we see tilting toward sustainability as an enduring source of potential returns. It is also an environment that we see supporting both sectors such as tech and healthcare – quality companies that are also beneficiaries of structural growth trends – as well as selected cyclical equities leveraged to the accelerated restart, such as emerging markets.

Second, we see the unusual dynamic between inflation, growth and markets – which we dub as *The new nominal* – as a key feature of the investment landscape for 2021 and beyond. We think the potential for higher medium-term inflation is underappreciated. The policy revolution implies that nominal yields will be less responsive to rising inflation. Together with a lower bound on bond yields and a greater reliance on fiscal policy, we see it challenging the role of government bonds in portfolios. In contrast to past inflationary episodes, we also believe that with less responsive yields, inflation can be good news for risk assets over a strategic horizon.

Third, we see a rewiring of globalization – reflected in our new *Globalization rewired* theme – rather than a simple trend toward deglobalization. We are witnessing the shaping up of a bipolar U.S.-China world order and a rewiring of global supply chains for greater resilience, with less focus on efficiency. We believe investors need exposure to both poles of global growth. Deliberate country diversification is key, and we see a case for greater exposure to China-exposed assets.

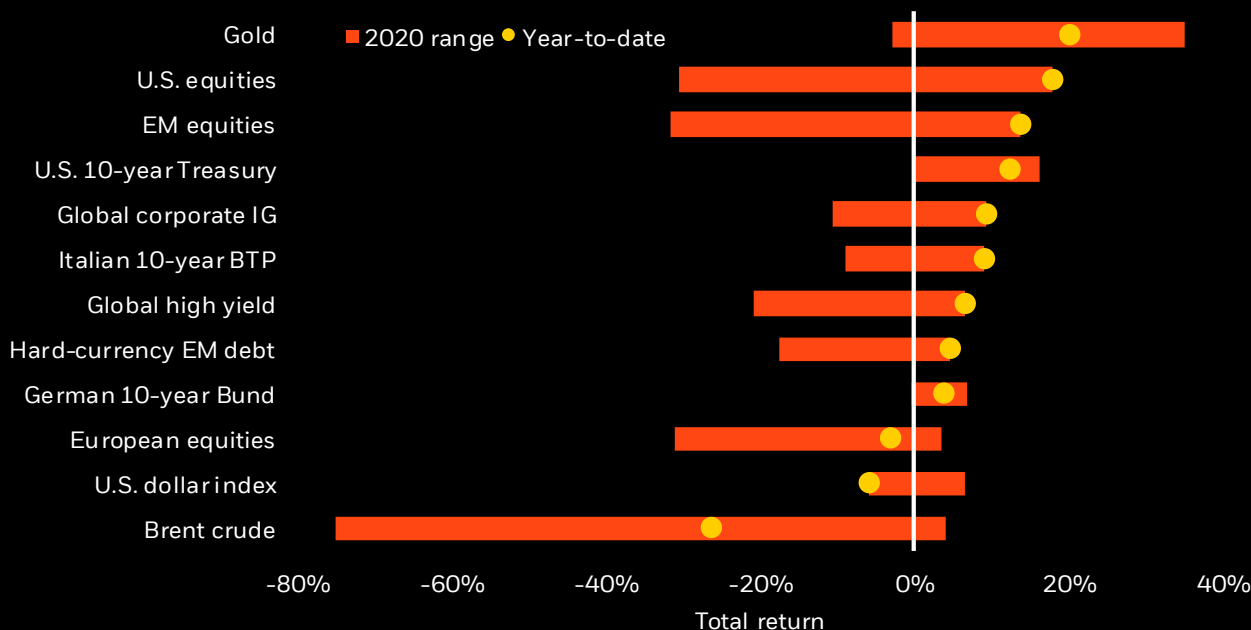
The bottom line: Positive news on vaccine development has reinforced our view that the cumulative economic shortfall caused by the pandemic – what matters most for financial markets – will likely be a fraction of that after the global financial crisis. This gives us greater confidence to increase our overall pro-risk stance. We have upgraded equities to overweight on a tactical basis, adding to our existing credit overweight. Read details in our [2021 global outlook](#).

Market backdrop

Global stocks hit record highs on upbeat vaccine developments and hopes for a U.S. fiscal package. Positive vaccine news has been a game changer for markets. We now know we are building a bridge to somewhere, providing clarity for policymakers, households and companies about getting to a post-Covid stage. Yet disappointing jobs data in recent weeks pointed to near-term risks as the virus surges around the U.S., potentially slowing the restart.

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, December 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.

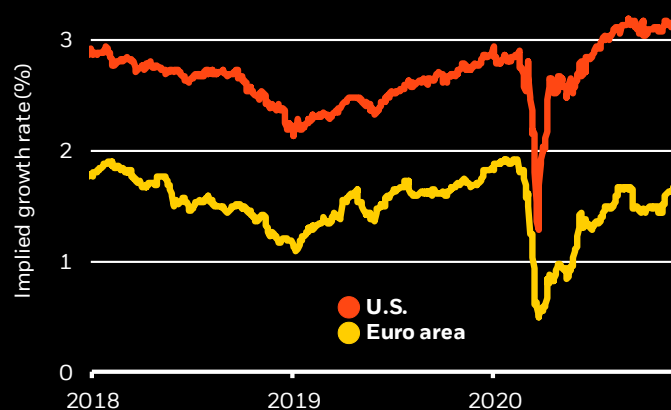
Macro insights

News on Covid vaccines strengthens the argument to ease monetary policy again, as policy support is more clearly building a bridge to a post-Covid world. Our financial conditions indicator shows how key developed market central banks have kept financial conditions as easy as they were before the Covid shock. The ECB is expected to ease further by boosting – and possibly extending – its Pandemic Emergency Purchase Programme this week.

Yet monetary policy space is limited, with interest rates near effective lower bounds. This leaves fiscal policy as the main tool to bridge lost income until global activity recovers. The risks around a fiscal extension in the U.S. are significant, given the lack of agreement to extend key measures such as enhanced unemployment insurance. In Europe, negotiations around the recovery fund and multi-year EU budget are being stalled by Poland and Hungary. Yet eventually an agreement is still more likely than not, in our view, lending important momentum to fiscal support through next year and beyond.

Keeping it easy

U.S. and euro area financial conditions indicators, 2018-2020



Sources: BlackRock Investment Institute and Bloomberg, December 2020. Notes: The lines show the BlackRock Financial Conditions Indicators (FCIs) for the U.S. and euro area, shown in terms of the consensus pace of growth implied by movements in domestic financial conditions.

Investment themes

1 The new nominal

- We see stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. Inflation will have different implications to the past.
- The policy revolution as a response to the Covid shock implies that nominal yields will be less responsive to rising inflation risk than in past episodes. This suggests risk assets will perform better than in past inflationary periods.
- Medium-term inflation risks look underappreciated. Production costs are set to rise on a rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past inflation undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- **Market implication:** We underweight government bonds and see equities supported by falling real rates in strategic portfolios. Tactically we are pro-risk, preferring U.S. equities and high yield credit.

2 Globalization rewired

- The pandemic has accelerated geopolitical transformations such as a bipolar U.S.-China world order, and a rewiring of global supply chains for greater resilience – with less emphasis on efficiency.
- Strategic U.S.-China rivalry looks here to stay, with competition and bifurcation in the tech sector at its core. We believe investors need exposure to both poles of global growth.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a clear case for greater exposure to China-exposed assets for returns and diversification, in our view.
- We expect persistent inflows to Asian assets as many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels, yuan depreciation and U.S.-China conflicts. But we believe investors are well compensated for these.
- **Market implication:** Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like EM equities, especially Asia ex-Japan, and are underweight Europe and Japan.

3 Turbocharged transformations

- The pandemic has added fuel to pre-existing structural trends such as an increased focus on sustainability, rising inequality within and across nations, and the dominance of e-commerce at the expense of traditional retail.
- The pandemic has focused attention on underappreciated sustainability-related factors and supply chain resilience.
- It has also accelerated "winner takes all" dynamics that have led to the outperformance of a handful of tech giants in recent years. Yet we see tech exposures as having long-term structural tailwinds despite their increased valuations.
- The pandemic has heightened the focus on inequalities within and across countries due to the varying quality of public health infrastructure – particularly across EMs – and access to healthcare.
- **Market implication:** Strategically we prefer sustainable assets amid a growing societal preference for sustainability. Tactically we take a barbell approach, favoring quality stocks balanced with selected cyclical exposures.

Week ahead

Dec. 7 German industrial output; China trade data **Dec. 10**

ECB monetary policy meeting; two-day European Council meeting starts

Dec. 8 German ZEW Indicator of Economic Sentiment





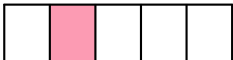



Dec. 11

University of Michigan Surveys of Consumers

The ECB is expected to increase the size of its Pandemic Emergency Purchase Program and possibly to ease terms of a long-term lending facility – against the backdrop of a worsening near-term growth outlook. This would follow its commitment to additional policy action in October. The European Council meeting will see the EU’s Recovery and Resilience Fund tabled again, with hopes to overcome opposition in Poland and Hungary.

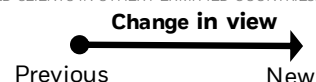
Directional views

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

Asset	Strategic view	Tactical view	Change in view Previous → New
Equities	 <p>Neutral</p>	 <p>+1</p> <p>We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We tilt toward EM equities. Tactically, we have upgraded equities to overweight as we expect the restart to re-accelerate and rates to stay low. We like a barbell approach: quality stocks balanced with selected cyclical exposures.</p>	
Credit	 <p>Neutral</p>	 <p>+1</p> <p>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 see the economic restart and ongoing policy support helping credit perform, even amid tighter yield spreads and the wind-down of some emergency credit support.</p>	
Govt bonds	 <p>-1</p>	 <p>Neutral</p> <p>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 policy accommodation suppresses yields.</p>	
Cash		 <p>Neutral</p> <p>We are neutral and use cash to fund overweights in equities and credit. Holding some cash makes sense, in our view, as a buffer against the risk of supply shocks that could drive both stocks and bonds lower.</p>	
Private markets	 <p>Neutral</p>	<p>Non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class not suitable for all investors.</p>	

Note: Views are from a U.S. dollar perspective, December 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



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

Asset	Underweight	Overweight		
Equities			United States	We have upgraded U.S. equities to overweight. We see the tech and healthcare sectors offering exposure to structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
			Euro area	We have downgraded European equities to underweight. The market has relatively high exposure to financials pressured by low rates. It also faces structural growth challenges, even given potential for catch-up growth in a vaccine-led revival.
			Japan	We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
			Emerging markets	We are overweight EM equities. We see them as principal beneficiaries of a vaccine-led global economic upswing in 2021. Other positives: our expectation of a flat to weaker U.S. dollar and more stable trade policy under a Biden administration.
			Asia ex-Japan	We are overweight Asia ex-Japan equities. Many Asian countries have effectively contained the virus – and are further ahead in the economic restart. We see the region’s tech orientation allowing it to benefit from structural growth trends.
			Momentum	We keep momentum at neutral. The factor could face challenges in the near term as a resurgence in Covid-19 cases and risks of fading fiscal policy support create potential for choppy markets.
			Value	We are neutral on value. The factor could benefit from an accelerated restart, but we believe that many of the cheapest companies – across a range of sectors – face structural challenges that have been exacerbated by the pandemic.
			Minimum volatility	We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
			Quality	We are overweight quality. We like tech companies with structural tailwinds and see companies with strong balance sheets and cash flows as resilient against a range of outcomes in the pandemic and economy.
			Size	We are overweight the U.S. size factor. We see small- and mid-cap U.S. companies as a key place where exposure to cyclical risk is likely to be rewarded amid a vaccine-led recovery.
Fixed Income			U.S. Treasuries	We are underweight U.S. Treasuries. We see nominal U.S. yields as staying rangebound, but real yields declining amid rising inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
			Treasury Inflation-Protected Securities	We are overweight TIPS. We see potential for higher inflation expectations to get increasingly priced in on the back of structurally accommodative monetary policy and increasing production costs.
			German bunds	We are neutral on bunds. 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.
			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.
			Global investment grade	We have downgraded investment grade credit to underweight. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
			Global high yield	We have trimmed our overweight in global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
			Emerging market – hard currency	We have upgraded hard-currency EM debt to neutral. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
			Emerging market – local currency	We have upgraded local-currency EM debt to neutral. We see catch-up potential as the asset class has lagged the risk asset recovery. Easy global monetary policy and a stable-to-weaker U.S. dollar should also underpin EM.
			Asia fixed income	We are overweight Asia fixed income. We see the asset class as attractively valued. Asian countries have done better in containing the virus and are further ahead in the economic restart.

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