Weekly commentary

July 6, 2020

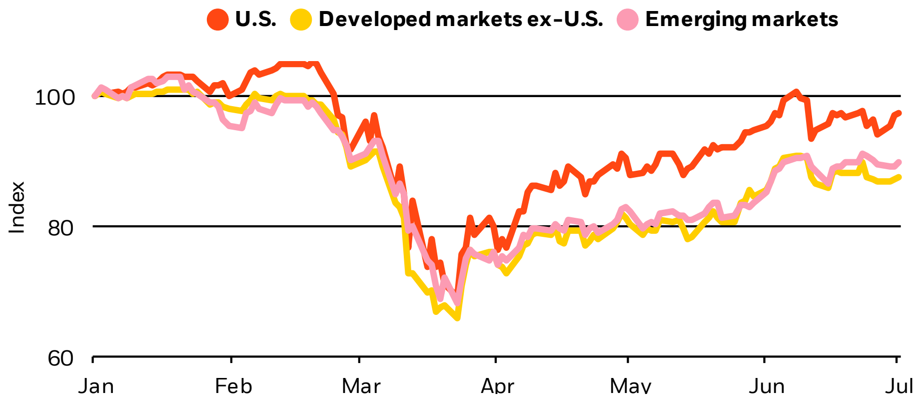
Downgrading U.S. equities to neutral

- We downgrade U.S. equities to neutral after a strong run amid surging COVID-19 cases and risks of fading fiscal stimulus.
- We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen.
- Markets this week will expect to see improving U.S. non-manufacturing and services purchasing managers' index data for June.

We have downgraded U.S. equities to neutral on a tactical basis, after a strong run of outperformance versus global equities since the March trough. We see a surge in COVID-19 cases in the U.S. potentially slowing the activity restart at a time when fiscal stimulus is at risk of waning. Yet the quality bias of the U.S. market lends some support and keeps us from turning negative.

Chart of the week

Selected regional equity market performance, year-to-date 2020



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute with data from Refinitiv, as of July 1, 2020. Notes: The lines show the performance of U.S., developed markets outside the U.S. and emerging markets, rebased to 100 on Jan. , 2020. The indexes used are the MSCI USA, MSCI World ex-U.S. and MSCI emerging Markets indexes.

U.S. stocks have outperformed in 2020, with a sharper recovery from the troughs of late March. See the chart above. This follows a multi-year stretch of outperformance of U.S. equities, driven by strong earnings growth as well as investor preference for tech and quality stocks. We now see a risk of more muted performance in line with global equities on a tactical horizon. New COVID-19 cases in the U.S. have been surging, prompting some states to roll back or pause their re-openings. This is potentially setting the U.S. on a very different activity restart path than most Western countries and much of Asia. Whether or not governments reimpose lockdowns, individuals may respond by reducing their mobility – as we observed at the onset of the pandemic. We view mobility as a key indicator of activity as economies restart, as detailed in our Midyear Outlook. As a result, failure to contain the virus may threaten America's activity restart.

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The outperformance of U.S. stocks in recent months has largely been supported by the historic policy response. The U.S. has so far delivered coordinated fiscal and monetary support sufficient to offset the estimated initial shock from the pandemic and spillovers to the full economy. Yet the resurgence of the virus is taking place just as Congress and the White House face a critical decision over whether to extend a number of crisis measures, including additional federal unemployment benefits set to expire at the end of July. Any premature reduction of stimulus in July, and as the shock persists, would increase the risk of financial vulnerabilities among businesses and households facing cashflow stresses. The risk of retrenching fiscal policy too soon in the U.S. comes as the euro area has been galvanizing its policy response to the coronavirus shock.

A slower economic restart could further dampen the earnings prospects of U.S. companies. Earnings per share of the benchmark S&P 500 Index are expected to decline 44% in the second quarter from a year earlier. That follows a 12.7% fall in the first quarter. Consensus estimates suggest U.S. corporate earnings will return to their 2019 levels by 2021, but we see downside risks given the likely slower restart. Renewed U.S.-China tensions and a looming presidential election with a historically wide gap between parties on policy add to the uncertainty.

What's stopping us from turning negative on U.S. equities then? The U.S. market has a high concentration of quality companies – especially in technology and communication services – that are set to benefit from structural trends accelerated by the pandemic. We have upgraded the quality style factor in our Midyear outlook to a strong overweight, preferring it as the most resilient exposure against a range of potential outcomes. And U.S. equity valuations do not look substantially out of line to us, with the equity risk premium above its long-term average.

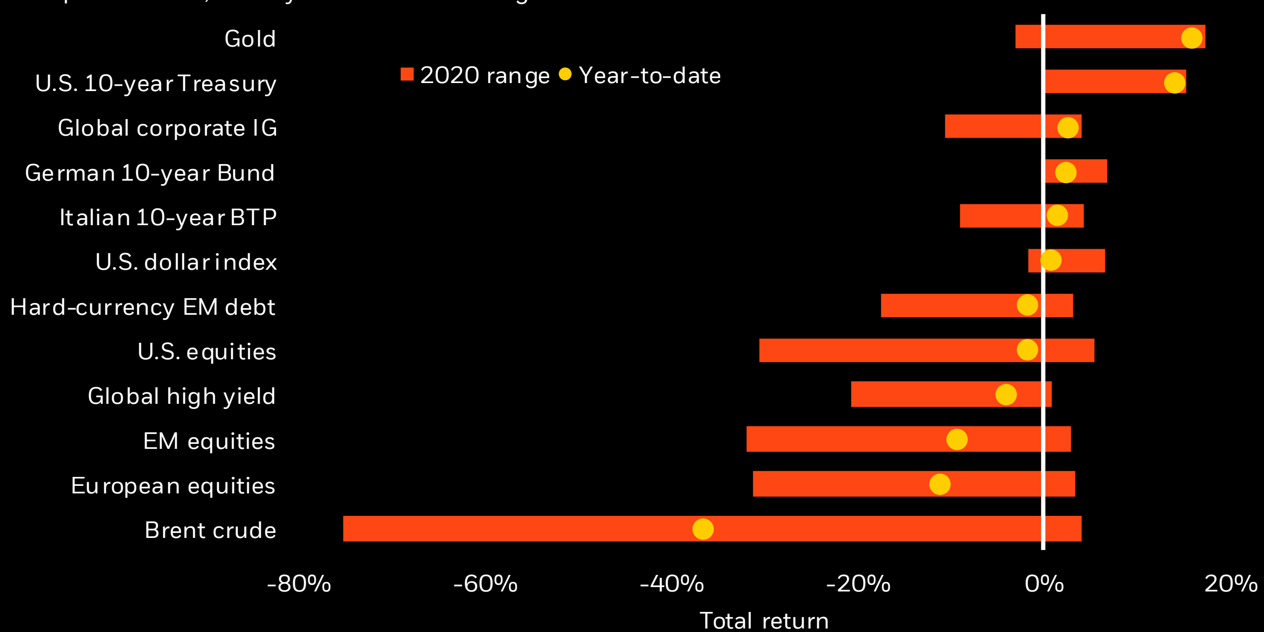
Bottom line: The resurgence of COVID-19 cases in the U.S. threatens the restart of activity, and has prompted us to downgrade U.S. equities to neutral over our six-to-12 month tactical horizon. Yet the relative quality bias of this market keeps us neutral overall. We prefer European equities, which we have upgraded to a tactical overweight. The region offers more attractive cyclical exposure than emerging markets due to its public health measures and ramped-up policy response, in our view.

Market backdrop

Measures to contain the virus have been gradually being eased in many developed economies, lifting activity and employment in June. A surge of COVID-19 cases in the U.S. threatens to slow the restart. We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen. The unprecedented policy response has boosted markets, leaving a potential resurgence of infections and policy implementation as key risks. U.S. Congress is headed for a fiscal cliff as jobless benefits, state support and payroll protection measures are expiring soon.

Assets in review

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



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent 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 Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

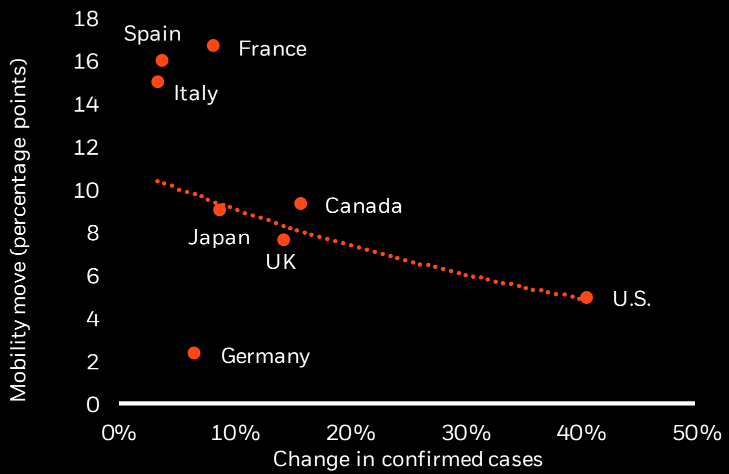
Macro insights

Coronavirus infection rates are rising again in some countries – notably the U.S. – as activity restarts. Markets are laser-focused on how well governments contain such secondary outbreaks to avoid scarring of the economy. European countries seem to have been more effective in this so far. The increase in infection rates poses a risk for the continued restart in activity.

We have seen a link between the number of infections and mobility data since the start of the crisis. The public has responded more rapidly to news about the outbreak itself than to changes in government lockdown rules. This relationship seems to hold as economies restart. The recent recovery in mobility as lockdowns have been eased has been far greater in countries reporting smaller changes in cases. See the chart. Better success in containing the coronavirus in Europe is going hand in hand with a stronger recovery in mobility and – as a result – activity. This implies activity may take a hit if infection rates surge - even where governments do not reinstate lockdowns.

A matter of mobility

Change in mobility data and coronavirus cases, May-June 2020



Sources: BlackRock Investment Institute, Oxford University and Google, with data from Haver Analytics, July 2020. Notes: The chart shows the change in Google mobility data (average of retail, recreation, workplace and transit) and the change in coronavirus cases for the countries labelled between May 29 and June 26, 2020.

Investment themes

1 Activity restart

- Economies are slowly restarting, but at different paces. We are tracking the evolution of the virus and mobility. The longer it takes for activity to restart, the more cracks might appear in the financial system and productive capacity.
- Shutdown measures are gradually being lifted in areas where infection rates have slowed, such as in North Asia and Europe. A surge in infections in U.S. Southern and Western states has partly reversed reopening measures there.
- The nature of the activity rebound will depend on the path of the outbreak, delivery of policy response and potential changes to consumer and corporate behaviors. Success will not just be about restarting the economy and containing the virus – but balancing both objectives.
- **Market implication**: We are moderately pro-risk, and express it in an overweight to credit in strategic, long-term portfolios. We prefer Europe among cyclical exposures on a tactical horizon.

2 Policy revolution

- The policy revolution was needed to cushion the devastating and deflationary impact of the virus shock. In the medium term, however, the blurring of monetary and fiscal policy could bring about upside inflation risks. It's crucial to have proper guard rails around policy coordination, as we discuss in Policy Revolution.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the shock and ensuring markets function properly, but has so far steered clear of committing to explicit yield curve control. U.S. Treasury set out a $3 trillion borrowing plan in its quarterly refunding to fund the response.
- After a slow start, Europe has followed suit, with the European Central Bank's new and more flexible quantitative easing as well as a proposed 750-billion-euro European recovery plan in addition to national stimulus measures.
- 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.
- We now see risks of policy exhaustion. Next rounds of U.S. fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship. And it may take time for European Union members to sign off on the European recovery plan.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically, we like credit as it's supported by central bank purchases, and see U.S. stocks as at risk of fading fiscal stimulus.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. Countries and sectors will make a comeback as diversifiers in a more fragmented world, in our view, offering resilience to real economy trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. Investors should consider alternative return sources that can provide diversification, such as private markets.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry 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 for strategic portfolios. We have raised our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

Week ahead

July 6	U.S. ISM non-manufacturing purchasing managers' index (PMI), services PMI; euro area retail sales
July 9	China inflation data
July 10–17	China money supply and total social financing

Markets will focus on the U.S. non-manufacturing and services PMI data this week. The reopening of the economy set the stage for e a rebound in manufacturing activity in the U.S. in June, and likely has also helped improve services sector activity. Yet a pickup in virus infections in June, particularly in the U.S., could weigh on July's high-frequency activity data. Markets are closely watching how well governments contain such outbreaks to avoid permanent scarring of the economy.

Directional views

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

Asset	Strategic view	Tactical view	
Equities	**Neutral**	**Neutral**	We have turned neutral on equities on a strategic horizon given the challenging backdrop for earnings and dividend payouts. We trim our modest overweight in EM and maintain our DM exposure at neutral. Tactically, we are also neutral on equities. We like the quality factor for its resilience and favor Europe among cyclical exposures.
Credit	**+1**	**+1**	We have moved to a strategic overweight on credit after being underweight for the past year. Sizeable spread widening compensates for the risks of defaults and downgrades, in our view. On a tactical horizon, extraordinary measures by central banks – including purchases of corporate debt – are supportive. Risks of a temporary liquidity crunch remain, but coupon income is crucial in a world starved for yield.
Govt bonds	**-1**	**Neutral**	The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. The "even-lower-for-even-longer" outlook for rates is compromising the asset class' ability to act as ballast against equity market selloffs in the long run. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation skews yields to the downside.
Cash		**Neutral**	We are neutral on cash and are using it to support our view on credit. Some cash makes sense as a buffer against supply shocks that 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 greater inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, July 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, July 2020

	Asset	Underweight / Overweight	
Equities	United States		We downgrade U.S. equities to neutral. 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 upgrade European equities to overweight. 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 upgrade Japanese equities to neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
Equities	Emerging markets		We downgrade emerging market equities to underweight. 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 downgrade Asia ex-Japan equities to 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 factor is now dominated by tech stocks on the one hand and defensives on the other, giving investors exposure to growth companies and some potential ballast.
Equities	Value		We upgrade value to neutral. 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 downgrade min vol to neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.
Equities	Quality		We increase our overweight in 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 like U.S. Treasuries. Long-term yields are likely to fall further than other developed market peers, even as low rates reduce their ability to cushion against risk asset selloffs.
Fixed Income	Treasury Inflation-Protected Securities		We are neutral on TIPS. A huge decline in rates makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
Fixed Income	German bunds		We remain underweight bunds as current yield levels provide little cushion against major risk events. Also, potential issuance related to the proposed EU recovery fund could compete with bunds for investment.
Fixed Income	Euro area peripherals		We 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 overweight global investment grade credit even as valuations have risen. Asset purchases by central banks and a broadly stable rates backdrop support the sector.
Fixed Income	Global high yield		We stay overweight high yield as a source of income despite recent underperformance. We avoid energy as lower oil prices challenge the ability of issuers to refinance near-term maturities.
Fixed Income	Emerging market – hard currency		We have downgraded 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 remain neutral on local-currency EM debt for its attractive coupon income. Currencies have adjusted and valuations have cheapened. A risk of further currency declines remains amid monetary and fiscal easing.
Fixed Income	Asia fixed income		We have turned 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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