

Weekly commentary

July 13, 2020



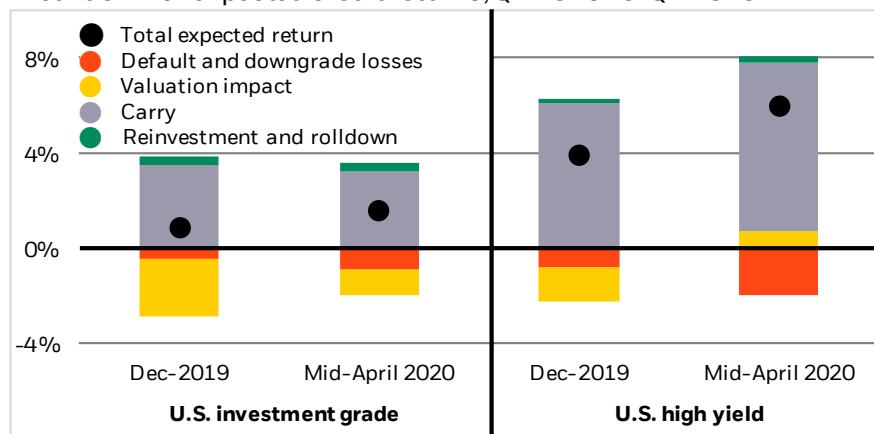
Why we like credit

- We like credit on a strategic basis as valuations compensate for default risks and we prefer credit over equities on a tactical basis.
- We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen.
- Markets this week will focus on a key European Union summit as leaders debate the region's economic recovery package.

We recently moved to a strategic overweight on credit after being underweight for the past year. Cheaper valuations compensated for the risk of corporate defaults and downgrades in the wake of the Covid-19 pandemic, in our view. We also prefer credit over equities on a tactical basis. Extraordinary central bank easing, including renewed purchases of corporate debt, underpin the asset class.

Chart of the week

Breakdown of expected credit returns, Q1 2020 vs. Q4 2019



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. Source: BlackRock Investment Institute. Notes: Chart shows 5-year expected returns for credit asset classes as at 31 Dec 2019 (Q4 2019) and as of April 14, 2020 (Q1 2020). The total expected return is broken down into expected loss due to default and downgrades and expected returns due to carry, valuation and rolldown or reinvestments of coupon income. Indexes used: Bloomberg Barclays U.S. Investment Grade Credit index and Bloomberg Barclays U.S. High Yield Index. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. There can be no guarantee any forecasts made will come to pass.

The pandemic has accelerated key structural trends, as detailed in our [Midyear Outlook](#), and calls for a wholesale review of strategic asset allocation. A key shift in our strategic views to ensure portfolios are resilient: We have updated credit to overweight. This reflects a rise in our five-year expected returns across credit sectors relative to our pre-virus expectations. Valuations in investment grade credit had cheapened significantly as of mid-April, and looked set to be less of a drag on future returns than they were in late 2019. See the shrinking yellow bars in the chart above. This effect more than outweighed the negative drag from an expected rise in losses resulting from corporate downgrades and defaults (the orange bars). In high yield, valuations swung to a modest tailwind for expected returns. Valuations have since risen, but still look fair to us.



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We maintain a modest pro-risk stance overall on a tactical basis, given our macro assessment of the virus shock and the strong policy response. This is balanced by a preference for assets that are high up the corporate capital structure and have policy backstops in the U.S. and Europe. These backstops go beyond investment grade credit and European peripherals, with the Federal Reserve for the first time purchasing “fallen angels” that have lost investment grade status. We prefer credit over equities as a result and are overweight in investment grade credit, high yield and euro area peripheral debt. These sectors offer attractive income in a world where decently yielding assets are hard to find. Credit (particularly high yield corporate debt) has lagged equities in the comeback rally, making it more attractive on a relative basis, in our view. Credit and equities also offer different sector exposures. Financials have a greater weight in credit, while tech has an outsized weight in equities. We prefer to take financials exposure in credit due to the strong policy backstop. Financial equities face challenges such as low rates and curbs on dividend payouts that could limit upside. And our overweight in the quality factor – even as we stay neutral overall in equities – gives us exposure to large-cap tech stocks riding secular trends.

The Federal Reserve is buying more assets relative to U.S. GDP than in the three rounds of quantitative easing that followed the global financial crisis combined. The Fed and European Central Bank look set to purchase roughly the equivalent of all the net supply across European and U.S. sovereign and corporate debt this year, by our calculations. To date, these purchases have been mostly of government debt, but the credibility of central banks’ corporate debt backstop has helped underpin credit markets. As such, investors have easily digested the highest run rate of new bond issuance since 1980 in global investment grade credit. We see issuance easing over the summer, providing a strong technical backdrop for credit.

Have credit markets already run too far? For now, we do not think so. Investment grade and peripheral bond spreads remain wider than pre-Covid levels. To be sure, the resurgence of Covid-19 cases in the U.S. poses near-term risks. But overall, we see the *policy revolution* and a strong investor appetite for income underpinning credit markets. Equity markets look more vulnerable to sagging corporate earnings, as well as any deterioration in the key signposts we are watching: how successful economies are at the *activity restart* while controlling the virus spread; whether stimulus is still reaching households and businesses in sufficient scale; and whether any signs of lasting economic scarring are emerging.

Market backdrop

Measures to contain the virus are being gradually eased in many developed economies, and lifted activity and employment in June. A surge of COVID-19 cases in many U.S. states threatens to undermine a recovery in mobility, which we see as closely tied to economic activity. The unprecedented policy response has boosted risk assets, leaving the U.S. resurgence of infections and policy implementation as key market 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.

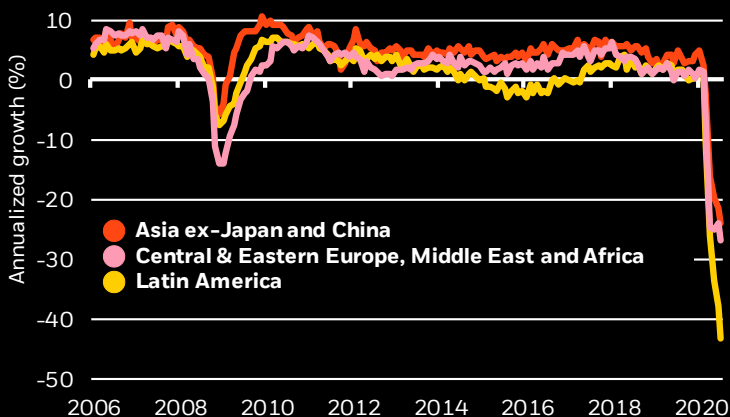
Macro insights

The coronavirus has hit emerging market (EM) economies hard. The impact of lockdowns was amplified by a sharp tightening in financial conditions, trade has been disrupted, and policy space is more limited than in developed markets. Yet there is wide dispersion within EMs, with some countries and regions better placed to recover than others. Our activity trackers show that Latin America has been more severely hit than Asia ex-Japan, and our [mid-year outlook](#) flagged how country selection is key.

Swift action by the Federal Reserve to offer U.S. dollar swap lines to EM central banks helped ease financial conditions. Yet trade remains a concern. EMs are exposed in the short term as the global economy only slowly stutters back to life, and in the longer run as the crisis accelerates deglobalization. Trade data for South Korea show to a pickup in exports, led by the technology sector. This is encouraging, but it may point to a stronger recovery in some EM economies with the right industry mix, rather than a broad-based EM rebound.

The emerging market divide

Bill emerging market activity trackers, 2006-2020



Sources: BlackRock Investment Institute, with data from Haver Analytics, July 2020. Note: The Bill activity trackers show the latest annualized growth projections obtained by using high-frequency data ranging from timely exports/imports data to confidence surveys. The key drivers of different sectors (services, manufacturing and others) are combined and then projected onto an aggregate growth measure to obtain a growth nowcast. A similar approach is used for country groupings.

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 equity 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. Any failure to renew key measures such as enhanced jobless benefits could hurt market sentiment. It may also take time for members of the the European Union to sign off on a 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 increased our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

Week ahead

July 14 ZEW economic sentiment survey

July 16

European Central Bank policy decision;
U.S. Philly Fed business survey

July 15 Bank of Japan policy decision





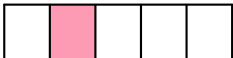



July 17-18

EU Summit; University of Michigan
consumer sentiment (prelim)

Leaders of the 27 EU member states are scheduled to hold their first physical summit since the coronavirus lockdown began. The two-day meeting will see leaders discuss an economic recovery package and the EU's next seven-year budget. Europe has ramped up its stimulus efforts in line with a much needed global policy revolution to cushion the coronavirus shock. This partly underpins our upgrade of European stocks to overweight, as detailed in our [Midyear Outlook](#).

Directional views

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

Asset	Strategic view	Tactical view
Equities	 <p>Neutral</p>	 <p>Neutral</p> <p>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.</p>
Credit	 <p>+1</p>	 <p>+1</p> <p>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.</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. 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.</p>
Cash		 <p>Neutral</p> <p>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.</p>
Private markets	 <p>Neutral</p>	<p>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.</p>

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.
	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.
	Japan	●	→	We upgrade Japanese equities to neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
	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.
	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.
	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.
	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.
	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.
	Quality		●	→
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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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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