# Weekly commentary

BlackRock

August 3, 2020

## Focusing on factors

- A trough in corporate earnings supports our decision to close an underweight in cyclical equity exposure such as value. We prefer quality for its resilience.
- Negotiations over the size and makeup of a new U.S. fiscal package are intensifying as key benefits expire and states face budget shortfalls.
- U.S. employment figures are in focus this week as this fiscal cliff nears and the pandemic's spread in Sunbelt states is starting to affect economic activity.


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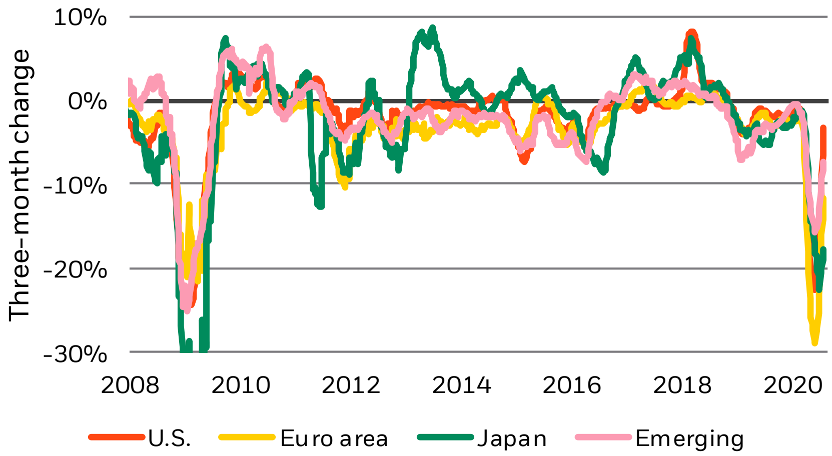
Corporate earnings estimates look to be troughing as economies reopen with fits and starts. We have increased our overweight in the quality factor because we see it as most resilient to the dynamics of a choppy *activity restart,* given its focus on companies with strong balance sheets and profitability. We also recently closed our underweight in cyclical assets, including upgrading the value factor to neutral.

### Chart of the week

Corporate earnings revisions across regions, 2007-2020




Source: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2020. Notes: The chart shows the three-month change in equity earnings revisions across regions. Earnings revisions are defined as the number of forward earnings estimate upgrades minus the number of estimate downgrades, expressed as a percentage of the total number of forward earnings estimates. Indexes used: MSCI USA, MSCI EMU, MSCI Japan and MSCI Emerging Markets.

The coronavirus shock dealt a historic shock to the real economy – and the biggest blow to corporate earnings since the 2008 financial crisis. Yet earnings revisions – or the ratio of upgrades to downgrades of corporate earnings estimates by analysts – look to have troughed in recent weeks. This is true across major regions, including emerging markets, as the chart above shows. Even the euro area (yellow line) – which saw the deepest trough – looks to have bottomed. The *activity restart* – one of the three key investment themes we explored in our Midyear Outlook – is a key reason for the increased optimism on the path of corporate earnings. To be sure, we expect this restart to be uneven over time and across regions. We see Europe as the most attractive exposure to a multi-speed global restart, as detailed in Favoring euro stocks in global restart.

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U.S. corporate earnings season is in full swing, with more than half of S&P 500 companies having delivered second-quarter scorecards. Roughly 80% of firms have beaten profit estimates, which had been slashed around 30% since January. Most sectors are seeing profits fall relative to a year ago, with energy earnings hardest hit. The tech and utilities sectors look on pace to register year-on-year earnings gains. Similar earnings trends are showing up in Europe and elsewhere. While the earnings cycle appears to have troughed, we believe consensus expectations for a return to 2019-level earnings next year may be overoptimistic. This points to downside risks if the activity restart is delayed – and policy stimulus fails to bridge households and businesses through the income shock. When assessing the impact of the shock on the economy, we focus on the cumulative GDP loss over time – or economic shortfall. Likewise, equity prices should reflect not just the near-term earnings outlook but the cumulative earnings loss versus the pre-virus trend. We expect this recovery to take several years.

Against this backdrop, we have increased the magnitude of our overweight in quality. We see quality companies – those with strong balance sheets, profitability and free cash flow – as those most resilient against the uncertainties in a multi-speed global economic restart. In addition, the factor includes many of the best-positioned companies in sectors such as tech, communication services and healthcare that are benefiting from secular growth trends that look to have been accelerated by the pandemic (think work from home). Many of these companies are found in the U.S. Yet we recently downgraded U.S. equities to neutral. Why? We previously preferred the U.S. for its strong policy response and quality bias. We still like the quality parts of the U.S. market, but have become more cautious overall due to a challenged public health backdrop and a risk of reduced fiscal policy support as key relief measures expire. This leads us to be increasingly cautious on broad U.S. exposures outside of those core quality holdings.

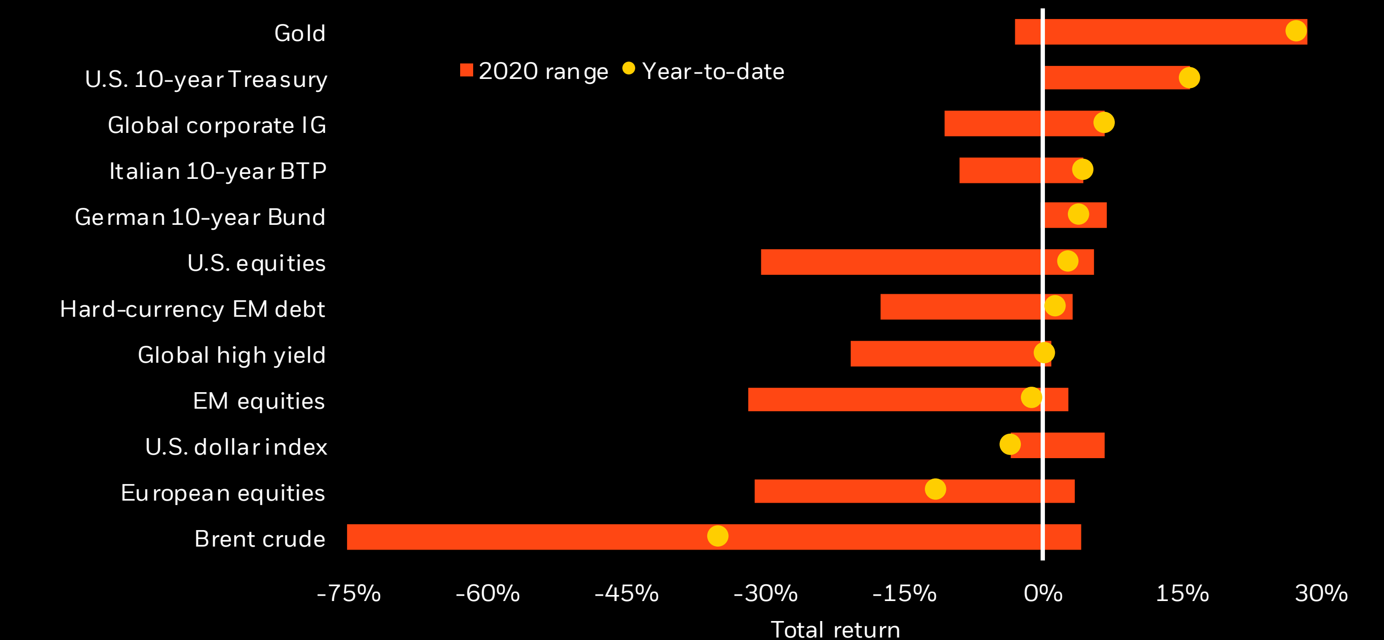
The differentiated global restart has also led us to close an underweight in cyclicality. This is reflected in our recent upgrade of the value factor to neutral – and a downgrade of min-vol to neutral. On a regional basis, we upgraded European equities to overweight and Japan to neutral from underweight, as we see these regions offering exposure to a cyclical uptick. Europe's strengthened policy framework is another positive. What about momentum? The factor has outperformed in 2020 to date, but we stay neutral given that the fits-and-starts economic restart may challenge trending exposures.

# Market backdrop

Activity has started to normalize in both Europe and North Asia, albeit with localized lockdowns to contain virus clusters. The pandemic is still spreading in the U.S. and many emerging markets. The unprecedented policy response has boosted risk assets. Europe has agreed on a historic recovery fund, but U.S. stimulus is now at risk of fading. Wrangling over the size and makeup of a new U.S. fiscal package is intensifying as key benefits expire and states face huge budget shortfalls. We could see a $1-1.5 trillion fiscal package that extends some (but not all) federal stimulus measures through late-2020.

## 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

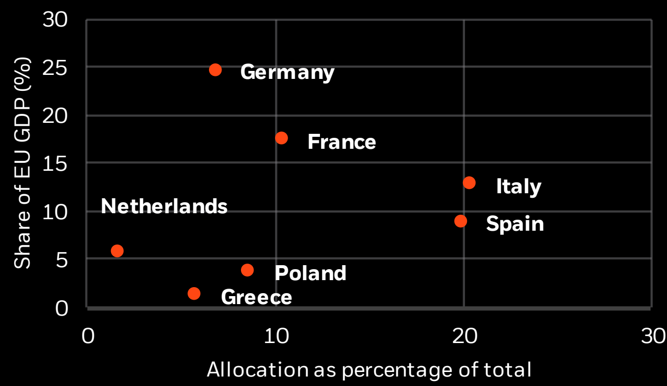
European activity continues to normalize thanks to a strong commitment from EU leaders to provide fiscal support and to structural reform to help economies and labor markets adapt to a post-Covid world.

The EU leaders' deal on the European Recovery and Resilience Facility (RRF) and multi-year budget will provide material fiscal support to European economies in the coming years, and comes on top of substantial national discretionary spending this year. The allocation of support is targeted toward countries most affected by the Covid-19 shock, with Italy and Spain set to benefit most as shown on the chart on the right. The RRF money will flow only from 2021 but current policy support is already boosting lending, ensuring credit flows to firms and providing an income bridge for lost revenue.

The progress so far does not imply a V-shaped recovery, in our view. A full recovery in the level of output will take some time. We are watching for longer-term shifts in consumer behaviour that may be harder to fix through policy.

## Fiscal support

Proposed allocation of RRF grants and loans to EU members




Source: BII, Eurostat, European Commission. Note: The horizontal axis shows a suggested allocation of the grants and loans in the EU Recovery and Resilience Facility (RRF) from the European Commission. This allocation is derived from EC staff simulations of the possible economic losses borne by member states as a result of Covid-19. The EC simulations are illustrative, and may differ from the ultimate allocation of RRF money as the RRF is still subject to the approval of the European Parliament and all member states, and part of the allocation will be determined by realized economic growth in economies over 2020-21.

# 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.
- Activity has restarted in North Asia and Europe, albeit with localized lockdowns to contain virus clusters. Surging infections in U.S. Sunbelt states have reversed reopening measures and started to affect activity 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.
- After a slow start, Europe has followed suit. The European Central Bank started fresh and more flexible quantitative easing. European leaders agreed on a historic €750 billion European recovery plan that introduces mutualized debt and creates jointly issued European bonds that can compete with other perceived safe-haven assets.
- EU leaders appear committed to the recovery plan, but it may take time to implement.
- 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 see a risk of policy exhaustion, especially in the U.S. Enhanced jobless benefits expired on Friday, with Congress still wrangling over an extension. We could see a $1-1.5 trillion fiscal package that extends some federal stimulus measures through late-2020. Aid to states and local governments is a key item, with many facing budget holes.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically, we overweight credit and European equities, and see U.S. stocks 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

| | | | |
|---|---|---|---|
| **Aug 3** | ISM U.S. manufacturing PMI | **Aug 6** | Bank of England policy decision |
| **Aug 4** | US factory orders MM | **Aug 7** | U.S. nonfarm payrolls report |

The U.S. monthly jobs report will be a major highlight as the country faces a fiscal cliff, with one key stimulus measure – an emergency extension of unemployment benefits – expiring. Congress still looks far from reaching a comprehensive deal but we could see a $1-1.5 trillion fiscal package that extends some federal stimulus measures through late-2020. Also in focus: Democratic presidential nominee Joe Biden is expected to unveil his pick for vice-presidential running mate.

# Directional views

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