Weekly commentary

BlackRock

Sept. 7, 2020

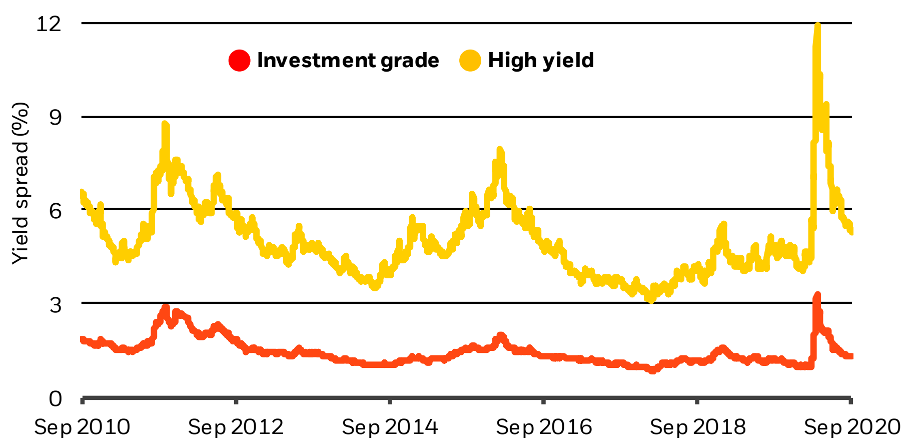
Changing credit views amid volatility

- We downgrade investment grade credit to neutral and increase our overweight in high yield as we see volatility rising after a rally in risk assets.
- Negotiations over a new U.S. fiscal package looked to have stalled. We still expect a sizable package, but risks of a no-deal outcome are growing.
- Markets will focus on the European Central Bank's updated projections and any policy implications. The traditional U.S. election campaign season kicks off.

Markets have rallied sharply from their virus lows, driven by the policy revolution and economic restart. Tighter valuations increase the risk of volatility, particularly ahead of divisive U.S. elections. Last week's equity selloff illustrates this. Against this background, we cut our tactical view on investment grade (IG) credit to neutral, but increase our overweight on high yield for its income potential.

Chart of the week

Investment grade and high yield credit yield spread, 2010-2020



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, September 2020. Notes: The lines show yield spread of investment grade and high yield credit over the past 10 years, represented by the option-adjusted spread of Bloomberg Barclays Global Aggregate Total Return Index and Bloomberg Barclays Global High Yield Total Return Index.

Yield spreads of both IG and high yield credit spiked in March as the coronavirus spread further globally. They peaked later that month – and started to decline – when central banks including the Federal Reserve launched extraordinary monetary policy support. IG spreads have shrunk more than half from the March 23 peak to under 1.3%, about where they were before the Covid spike, as the orange line in the chart shows. The risk/reward balance now looks much less appealing: The extraordinary monetary policy support has already priced in, and IG is offering little buffer against risks such as rising rates due to its interest rate-sensitive nature, in our view. High yield spreads have also narrowed sharply from late March (see the yellow line), yet there may still be room for further tightening, in our view, particularly as the economic restart gains steam.

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The policy response to the virus shock has been a major driver of markets, but its composition over coming months will likely be different from what we've seen. We see limited room or appetite for central banks to further cut interest rates or ramp up asset purchases – a driver behind the recent compression in credit spreads. Fiscal policy is becoming key in the ongoing policy revolution, and the quantitative easing programs of major central banks help offset some downside risks. As a result, for now we stay overweight credit on a tactical basis and neutral on equities over both a tactical and strategic horizon. We see a growing risk that fiscal policy support dries up in the U.S. – barring a Democratic sweep in November that would pave the way for a boost to spending. Our base case, however, still calls for a new fiscal package of up to $2 trillion.

Our stronger preference for high yield is also supported by fundamentals that appear disconnected from market pricing. The current pricing implies around 25% of the bonds on the Bloomberg Barclays U.S. Corporate High Yield Index could default over the next five years, our calculations showed. This has fallen from the 40% implied rate in April, but is still higher than a median actual default rate of 19% since 1990. Many high yield issuers have been able to access the capital market for their liquidity needs over the past few months, likely helping them weather any further economic turmoil caused by the virus shock. We expect mid- to high- single digit high yield default rates over the coming year. Yet many of the victims will likely be companies with the weakest balance sheets that were already prime candidates for default in coming years, in our view. We value high yield as a source of income in low-yield world, and expect it to outperform IG once growth reaccelerate.

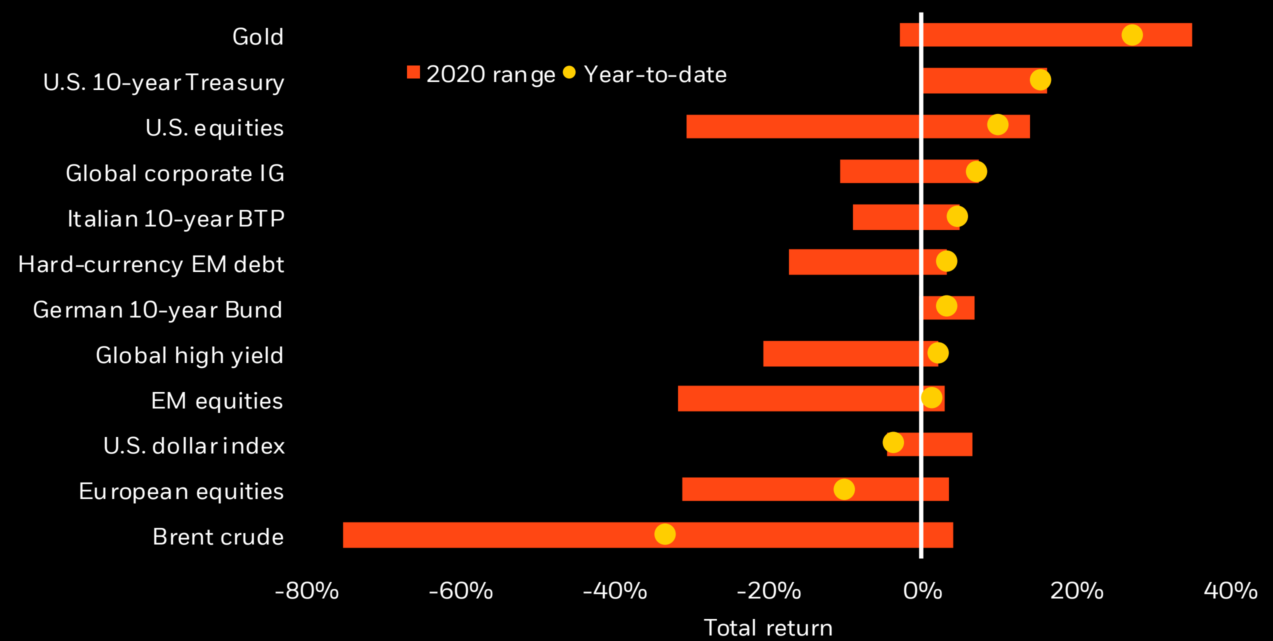
The bottom line: We stay moderately overweight on credit overall on a tactical basis for now. We strongly favor high yield, and are neutral on IG. We are still overweight U.S. Treasuries over the next six to 12 months as ballast against uncertainties around the pandemic and U.S. election. Yet over the strategic horizon we advocate reducing allocation to nominal developed market (DM) government bonds as interest rates are near their lower bounds and medium-term inflation risks grow. On a tactical basis we have also downgraded EM local-currency debt and are underweight hard-currency EM debt too, as we generally prefer to take risk in developed markets. Many EM countries have insufficient public health systems to control the virus spread and less policy space to cushion the economic blow. Yet we are neutral on Asia fixed income given China's ongoing recovery from the virus shock.

Market backdrop

Activity has started to normalize around the globe, albeit with renewed localized lockdowns to contain virus clusters. Market volatility is returning after months of steady advances in risk assets. Valuations have risen, and we could see greater volatility in coming months as a result, especially as the U.S. election closes in. A contributing factor: Negotiations over the size and makeup of a new U.S. fiscal stimulus package have stalled. In addition, the pandemic is still spreading in many countries, and U.S.-China tensions have escalated.

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, September 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.

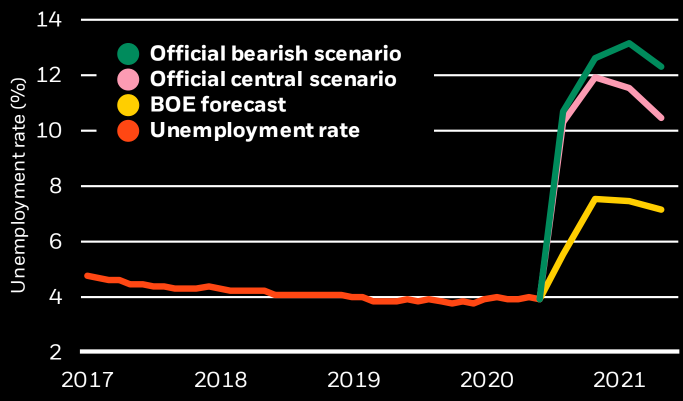
Macro insights

The UK has been one of the DM economies hardest hit by the Covid-19 pandemic, with economic output shrinking sharply from pre-Covid levels. Activity has restarted slowly and mobility lags other DM countries because the lockdown was lifted later. The UK's edition of the policy revolution saw comprehensive and coordinated monetary and fiscal easing, providing a bridge for disrupted cash flows. A key risk: The labor market furlough program is set to expire at the end of October. The Bank of England forecasts unemployment could nearly double by the year end, and the official Office for Budget Responsibility points to more severe scenarios.

Brexit trade talks will come into focus as the Dec. 31 deadline looms – potentially denting confidence in the restart. Additional policy support – most likely more asset purchases – may be called for if the activity data weaken again and the important services sector continues to struggle. Further fiscal support may also be necessary.

Unemployment concerns

UK unemployment rate and official forecasts, Sept. 2020



Sources: BlackRock Investment Institute, Bank of England, Office for Budget Responsibility (OBR) and the Office for National Statistics, with data from Haver Analytics, September 2020. Notes: The orange line shows the three-month trailing average unemployment rate. The yellow line shows the Bank of England's August 2020 forecast, assuming policy rates follow the path implied by financial markets. The green line shows the OBR's central scenario for unemployment published in the July 2020 Fiscal Sustainability Report. The pink line shows the OBR's downside scenario. Forecasts may not come to pass.

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 is restarting around the globe, albeit with localized lockdowns to contain virus clusters. The surge of new infections in U.S. Sun Belt states looks to have peaked, but has resulted in a reversal of some reopening measures and is affecting activity. Europe has seen a pickup in cases but nowhere on the same scale as the U.S.
- 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 guardrails 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. The Fed has adopted a flexible version of average-inflation targeting that will mean it will tolerate above-target inflation for a certain period of time to make up for past misses.
- 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. Negotiations on new fiscal relief measures have stalled. We could see a package up to $2 trillion that extends some federal stimulus measures through late-2020, but there are growing risks for a no-deal outcome with the end-September budget deadline looming.
- **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

Sept. 7	China preliminary trade data	**Sept. 11**	U.S. consumer price index
Sept. 10	European Central Bank (ECB) monetary policy meeting	**Sept. 10-17**	China total financing and new yuan loans

Markets will focus on the ECB this week, particularly their updated economic projections and the implications for policy. The central bank is expected to keep interest rates unchanged. The traditional election campaign season is kicking off in the U.S. with the poll date only eight weeks away. Former Vice President Joe Biden currently leads President Donald Trump by just over 7 percentage points, according to an average of national polls by FiveThirtyEight, an influential forecasting site.

Directional views

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

Asset	Strategic view	Tactical view	
Equities	Neutral	Neutral	We have turned neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall . We like the quality factor for its resilience and favor Europe among cyclical exposures.
Credit	Neutral	+1	We have turned 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 strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
Govt bonds	-1	Neutral	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 unprecedented policy accommodation suppresses yields.
Cash		Neutral	We are neutral on cash. Holding some cash makes sense as a buffer against supply shocks that could 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 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

Change in view

Previous → New

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

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. 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 are overweight European equities. 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 keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
Equities	Emerging markets	■		We are underweight emerging market equities. 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 hold Asia ex-Japan equities at 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 are neutral on value. 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 hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.
Equities	Quality		■■	We keep our strong overweight on 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 still 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 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.
Fixed Income	Global investment grade			We downgrade investment grade credit to neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
Fixed Income	Global high yield		■■	We increase our overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
Fixed Income	Emerging market – hard currency	■		We are underweight 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 have downgraded local-currency EM debt to underweight. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
Fixed Income	Asia fixed income			We are 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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