Weekly commentary

BlackRock

Jan. 11, 2021

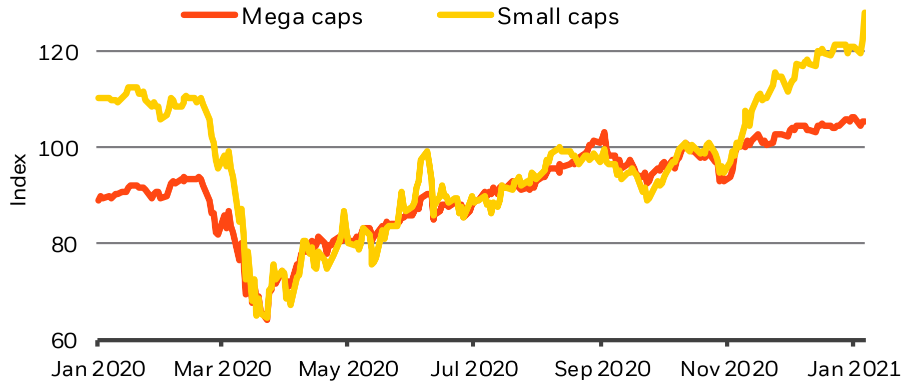
The new nominal, accelerated

- The Democrats gained a slim majority in the Senate, paving the way for greater public spending and reinforcing our macro outlook.
- A more infectious virus strain could delay the activity restart but we see the cumulative economic loss as a fraction of that seen after the 2008 crisis.
- The pace of vaccine rollout amid a virus resurgence will stay in focus in a week of few data releases. Markets have so far shrugged off rioting on Capitol Hill.

The Democrats' newly gained majority in U.S. Congress paves the way for greater public spending but the narrow margin limits the scope for higher taxes, in our view. We expect this outcome to speed up "the new nominal", or our expectations for stronger growth coupled with stable nominal yields, even as a more infectious virus strain threatens to make the path to a full activity restart more bumpy.

Chart of the week

Performance of U.S. mega-cap and small-cap stocks, 2020-2021



Past performance is no guarantee of future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv, January 2021. Notes: U.S. mega-cap stocks are represented by the S&P 100 Index, and small-cap stocks by the S&P 600 Index. Performance is rebased to 100 on Nov. 6, 2020, the last trading day before major news organizations declared Democratic candidate Joe Biden had won the presidential election, as well as Pfizer and BioNTech announced the preliminary Covid vaccine efficacy data.

The new virus strain has sent hospitalizations spiking in the UK where it was first detected, and is spreading globally, posing serious challenges to efforts to beat back the virus. It could delay the activity restart in the near term and increase the time needed for the economy to return to its pre-virus trend. Yet ultimately we still expect the cumulative economic activity loss from the Covid shock – what matters for markets – to be just a fraction of that seen after the global financial crisis, and believe investors should look through any market volatility triggered by evolving virus dynamics. The rollout of vaccines is off to a slow start, yet we believe once vaccination becomes widespread it will allow a more forceful restart due to the pent-up demand. As part of our overall pro-risk stance, we are overweight U.S. small- and mid-cap stocks as we see them benefitting from the vaccine-led restart. The prospects for more fiscal spending under a united Democratic government could further fuel the ascent of small caps, after they have significantly outperformed mega caps since the U.S. election, as the chart shows.


Jean Boivin
Head – BlackRock Investment Institute


Elga Bartsch
Head of Macro Research – BlackRock Investment Institute


Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute


Kurt Reiman
Senior Strategist for North America – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on global economy, markets and geopolitics.

BlackRock **Investment** Institute

We expect significant fiscal support relative to a scenario of ongoing Republican control of the Senate. This could accelerate our *new nominal* theme, pushing inflation higher over time but with the Federal Reserve keeping the rise in U.S. Treasury yields in check. It also reinforces our *turbocharged transformations* theme, including the tectonic shift toward sustainability. A Democratic majority could pave the way for major green investment. Last week's market reaction was consistent with this view. Treasury yields breached 1% for the first time since last March, driven by increases in both inflation expectations and real yields. This suggests markets are likely to test the Fed's resolve to lean against any excessive climb in nominal yields. We expect greater fiscal spending to be largely funded through increased deficits rather than higher taxes, given the Democrats' slim majority in both chambers of Congress. The policy revolution has brought on greater tolerance for higher debt globally, yet just how long such attitudes could last is key. Modest increases in corporate taxes may be possible, but large-scale changes including raising taxes on high-income earners, appear unlikely, in our view. Democratic control of the Senate will likely lead to smooth confirmation of nominees to head the regulatory agencies that are crucial for policymaking.

The first half of 2021 is likely to be a choppy ride. The pandemic poses serious challenges to public health and the activity restart, while we see more policy support in the U.S. on top of the recent $900 billion fiscal package. We advocate a barbell approach to risk exposures, with selected cyclicals such as U.S. small-caps and emerging market equities on one end and quality assets including U.S. and Asia ex-Japan equities on the other. We also like tech and healthcare. These sectors benefit from structural trends turbocharged by the pandemic and their strong balance sheets and cash flows provide some resilience against volatility. Yet we recognize U.S. tech could face challenges from greater regulation and corporate taxes.

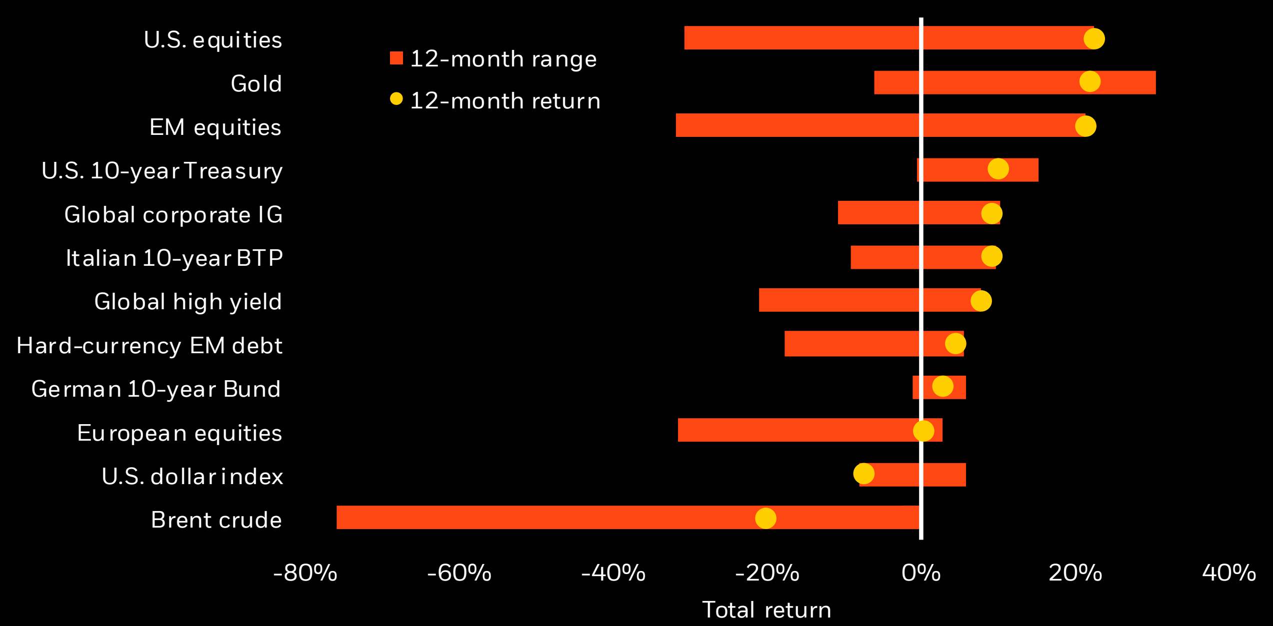
Bottom line: The new slim Democratic majority in Congress boosts our expectations for more public spending without commensurate tax increases. We also expect a strong vaccine-led restart later in the year. All this reinforces our view on growth, rates and inflation, and underpins our preference for inflation-protected securities over nominal U.S. Treasuries. We expect the Fed to lean against any further spike in nominal bond yields. We remain pro-risk overall, favoring overweights in both equities and credit, but see a potentially bumpy path for asset prices broadly, especially as markets have moved a lot since we published our 2021 global outlook in early December.

Market backdrop

U.S. stock markets rallied to record highs and bond yield rose after the Democrats won two Senate runoff elections in Georgia and gained a slim majority in Congress. President-elect Joe Biden can now push through policy priorities, including regulatory appointments, fiscal stimulus and spending on green initiatives, whereas the Democrats' narrow majority limits large-scale tax increases. Markets largely shrugged off rioting on Capitol Hill that interrupted Congress' certification of the presidential election result. The vaccine rollout has been slow as a more infectious strain of the virus is spreading, but we don't see it materially changing the cumulative economic impact of the virus shock.

Assets in review

Selected asset performance in the past 12 months



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, January 2021. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared with 12 months earlier. 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 US. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

Macro insights

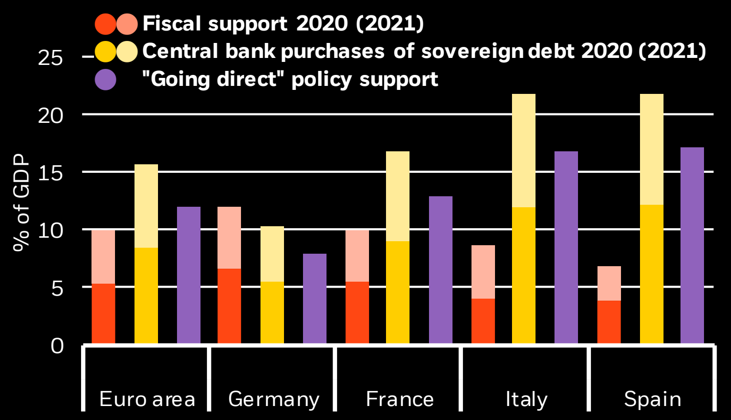
The interaction between virus dynamics and the vaccine rollout will be a key driver of the activity restart in Europe in coming months. A new, more infectious strain tilts risks to the downside, independent of a successful vaccine rollout, in our view. This could lead to further downward revisions in consensus forecasts in coming weeks.

There is still ample policy support at the national level and pan-European level, as shown on the chart on the right. The region's fiscal response is being lined up with the EU Recovery and Resilience Fund in coming months. Yet renewed lockdowns triggered by the spread of the new strain could trigger a need for additional support to prevent scarring of the potential growth in Europe.

One complication for the European Central Bank's policy stance, and for euro area policy makers more broadly, is a likely deepening of the divergence in economic performance between member states if the economic restart is postponed due to the new virus mutation.

Policy support on par with last year

Euro area fiscal and monetary support, 2020-2021



Sources: BlackRock Investment Institute, with data from Haver Analytics, December 2020. Note: The orange bars show estimates of the discretionary fiscal measures in 2020 and 2021 in response to the pandemic. The purple bars show the direct central bank support via programs such as the euro area's Targeted Longer-Term Refinancing Operations. The yellow bars show central bank purchases of sovereign debt. Bars of darker shades represent 2020, and those of lighter shades 2021.

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.
- The Democrats' newly gained slim majority in U.S. Congress improves the outlook for fiscal spending, likely fast tracking our expectations for stronger growth and lower real yields.
- 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**: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by falling real rates. 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. We see tech as having long-term structural tailwinds despite its increased valuations, yet it could face challenges from higher corporate taxes and tighter regulation under a united Democratic government.
- 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

Jan. 11 China total social financing

Jan. 15 University of Michigan Surveys of Consumers; U.S. industrial production

The pace of vaccine rollout amid a virus resurgence will stay in focus in a week of relatively few data releases. The University of Michigan Surveys of Consumers could shed light the health of consumer spending. The U.S. consumer sector, a key pillar of the economy, has shown signs of weakness in recent months. Retail sales declined for two straight months in October and November as Covid hospitalizations and restrictions grew.

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	**Neutral**	**+1**	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.
Credit	**Neutral**	**+1**	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.
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 policy accommodation suppresses yields.
Cash		**Neutral**	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.
Private markets	**Neutral**		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.

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

Change in view
Previous → New

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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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 cyclicality 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.
Fixed Income	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.
Fixed Income	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.
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 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.
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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee