FOR PUBLIC DISTRIBUTION IN THE U.S., HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

Weekly commentary

Feb. 1, 2021

BlackRock

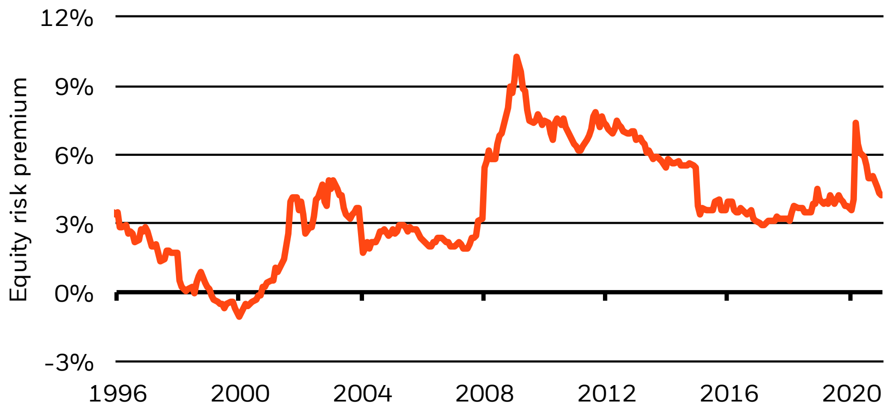
Valuation: not a worry for now

- We see the activity restart and persistent low interest rates supporting equities, even as markets have rallied and pockets of excess have emerged.
- The Federal Reserve's statement reaffirmed a low-for-long interest rate outlook, backing our *new nominal* theme.
- This week's nonfarm payrolls and global purchasing managers' index (PMI) data will be in focus for assessing the U.S. labor market and global activity.

Equity valuations have been top of mind after major stock indexes have scaled new highs. Last week's volatile market moves as a result of technical deleveraging added fuel to these concerns. We do not see risk asset valuations as obviously stretched overall, and expect low interest rates – and a vaccine-led restart – to support risk assets over the next six to 12 months.

Chart of the week

Estimated U.S. equity risk premium, 1996-2020



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 Datastream. Data are as of Jan. 28, 2021. Notes: We use the implied equity risk premium that incorporates current market prices, expected future cashflows and risk-free rates. We use MSCI USA Index to represent U.S. equities.

Assessing equity valuations can be difficult. Structural shifts such as persistently lower interest rates make it difficult to judge the signals from traditional metrics such as price-to-earnings ratios. The key question is whether the compensation investors are getting to take on additional equity risk, after factoring in current low interest rates, is fair. This is why we prefer to gauge valuation by looking at the expected return of equities over the risk-free rate, and our estimates for the U.S. market don't appear stretched, as the chart above shows. This approach helps us assess valuations across different interest rate environments, yet the metric is only as good as the assumptions that go into it. Our *new nominal* theme suggests rates will stay low amid stronger growth and higher inflation, as central banks lean against any sharp rises in nominal rates. This should keep "real", or inflation-adjusted yields, negative, and support risk assets, in our view. But if rates were to revert to historical averages, valuations would look a lot more stretched.

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BlackRock **Investment** Institute

The S&P 500 Index posted its biggest one-day decline in three months last Wednesday. Large price swings in a small set of stocks that have been popular targets of short sellers led to a wave of technical deleveraging that hit the market. The dramatic rise in share prices of these stocks triggered forced selling of other equities as some investors sought to cover their short positions. Worries about market exuberance are natural in such a climate, but we believe these stock swings are isolated instances triggered by market technicals – and are the wrong thing to focus on.

The more fundamental question: have markets moved too far, too fast? Global stocks have risen 16% from a year earlier – just before the start of the global pandemic that has killed over two million and forced unprecedented activity stoppage. Tech stocks have led the charge, with the Nasdaq 100 Index up over 40%. We don't see a disconnect – because of the nature and visibility of this shock. We view it as akin to a natural disaster followed by a rapid activity restart, and see the cumulative economic shortfall as just a fraction of that seen after the global financial crisis – an outlook markets have been quick to price in. Valuations do not look obviously stretched, as our estimate of the compensation for taking equity risk shows. The flip side: The eventual restart may not give stocks as much of a lift as past recoveries. Earnings growth will likely need to be the primary driver of returns given today's valuations, and we see potential for a strong earnings rebound ahead.

The equity rally does have implications for longer-term returns. We now see equity valuations as fair in our long-term capital market assumptions – and expect lower returns ahead as a result. This is why we are neutral on equities over a strategic horizon. What could change the benign environment for risk assets? An unexpected rise in rates could occur if the relaxed attitude of market participants to record high public debt loads were to change – and central banks abandoned their stance of leaning against any sharp rises in nominal rates. Our *new nominal* theme suggests this risk is low for now, but any change in the tolerance for high debt levels could flip this dynamic in the medium term, with major market implications.

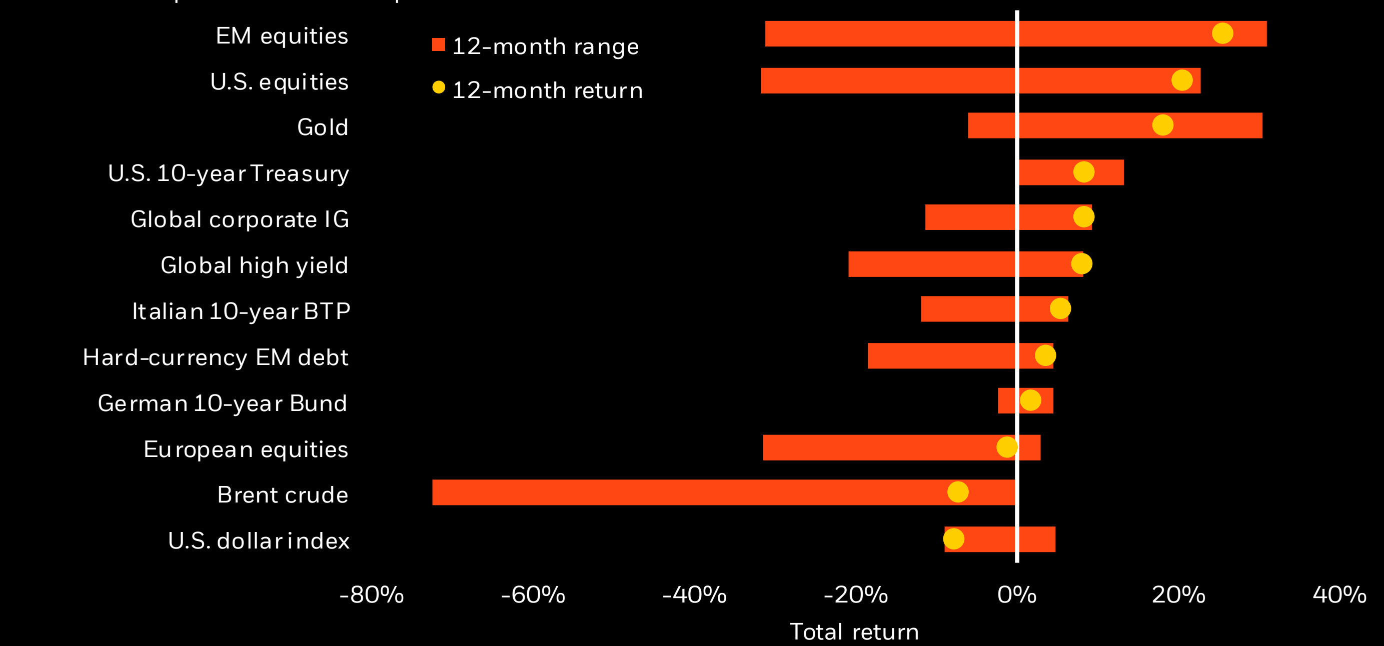
The bottom line: We do not see overall equity valuations as being stretched today, although easy financial conditions and pockets of excess could spark further bouts of volatility. We are pro-risk overall on a tactical basis, and overweight equities and credit. We favor a barbell approach in equities: quality stocks on one end to counter any hiccups caused by the slow vaccine rollout and the spread of new strains; and selected cyclicals on the other to capture the upswing led by the restart.

Market backdrop

U.S. stocks scaled new highs before selling off briefly as large price swings in a small set of stocks that have been popular targets of short sellers lead to a wave of technical deleveraging. More than 30% of S&P 500 companies have reported fourth-quarter earnings, with over 80% beating expectations, according to Refinitiv. The Fed flagged a brighter economic outlook despite a recent soft patch and reinforced expectations for "low for long" rates, backing our new nominal theme.

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 U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

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Macro insights

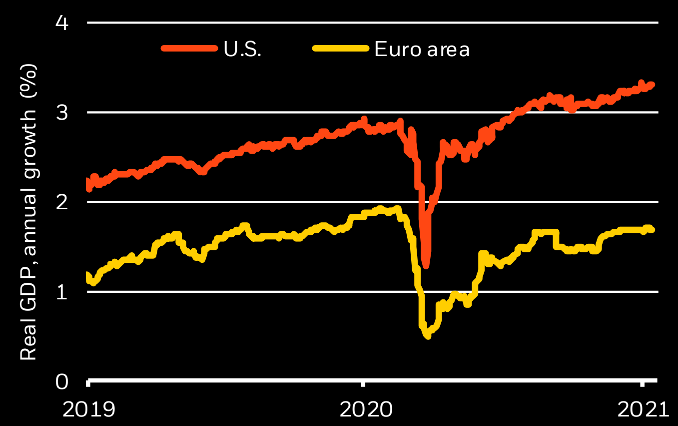
We expect central banks to maintain their extremely easy policy stance, despite the prospect of an accelerated activity restart later this year. The Fed and European Central Bank have reiterated their commitment to maintaining monetary policy support until inflation rises meaningfully toward targets. Yet we expect a more muted reaction in policy rates even if inflation expectations continue their climb. Consequently, financial conditions are likely to stay supportive of growth, as shown in the chart.

Fed expectations for a rise in inflation have typically gone hand in hand with a rise in the projected policy rate. Yet the policy rate has become less sensitive to changes in the inflation outlook – a trend we expect to be cemented by the Fed's shift in its policy framework to allow inflation overshoots to make up for past undershoots.

The bottom line: In the *new nominal* environment, inflation can rise and even materially overshoot its target. Yet we will likely see a far smaller rise in policy rates and nominal bond yields than in the past.

Easy financial conditions

BlackRock FCI for U.S. and the euro area, 2019-2021



Source: BlackRock Investment Institute, Jan 2021. The financial conditions indicator (FCI) shows the implied rate of GDP based on its historical relationship with our growth GPS. The BlackRock Growth GPS shows where the 12-month forward consensus GDP forecast may stand in three months' time. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates.

Investment themes

1 The new nominal

- We see stronger growth and low-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' slim majority in U.S. Congress improves the outlook for fiscal spending, likely fast tracking our expectations for stronger growth and low real yields.
- Medium-term inflation risks look underappreciated. Production costs are set to rise amid the rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- The policy revolution has led to a surge in public debt – and increased tolerance for it. We don't see high debt levels as a concern in the near term. Yet there are risks bubbling below the surface – over time we could see a change in the premium for the perceived safety of government debt, with major market implications.
- **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. We believe investors need exposure to both poles of global growth.
- Strategic U.S.-China rivalry looks here to stay, particularly in tech. The Biden administration is likely to shift away from a focus on bilateral trade deficits to a multi-lateral approach. It will also seek to balance cooperation on climate change and public health within a broader U.S.-China agenda that includes areas of potential heightened tensions such as trade and human rights.
- 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.

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Week ahead

Feb. 1	Manufacturing purchasing managers' index (PMI) for China, euro area and the U.S.
Feb. 2	Euro area preliminary flash GDP
Feb. 3	Services PMI for China the U.S.; composite PMI for the euro area
Feb. 5	U.S. nonfarm payrolls

This week's U.S. nonfarm payrolls data will be in focus. Economists polled by Reuters expect an increase of 85,000 jobs, after a decrease of 140,000 in December – the first decline in eight months. The jobs report comes on the heels of the Fed policy meeting last week where policymakers downgraded the near-term outlook but upgraded the assessment further out.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, January 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
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 are overweight equities 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, January 2021. 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.

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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, January 2021

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities. 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 are underweight European equities. 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 been more effective at containing 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 has become more exposed to cyclicality, could face challenges in the near term as a resurgence in Covid-19 cases and a slow start to the vaccination efforts create potential for choppy markets.
Equities	Value			We are neutral on value despite its recent outperformance. 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.
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, significant fiscal spending, 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 political events in Italy. We see further rate compression due to ongoing support from the European Central Bank and other policy actions.
Fixed Income	Global investment grade	■		We are underweight investment grade credit. 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 are moderately overweight 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 are neutral hard-currency EM debt. 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 are neutral local-currency EM debt. 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.

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