Weekly commentary

BlackRock

Feb. 16, 2021

Fiscal boost is not a market risk – yet

- We see central banks keeping a lid on yield rises for now, yet there is a risk that rising debt levels and inflation eventually threaten the low-rate regime.
- Rising inflation expectations have driven up U.S. 10-year Treasury yields but to a lesser degree than in the past, in line with our *new nominal* theme.
- Sentiment data in the U.S. and Europe could shed light on the status of the activity restart amid tightened virus restrictions.

The prospect of another large U.S. fiscal package has fed debates about potential economic overheating. We believe central banks for now have strong incentives to lean against any rapid rise in nominal yields even as inflation rises, supporting our tactically pro-risk stance. Yet rising debt levels may eventually pose risks to the low-rate regime. This is part of why we strategically underweight government debt.

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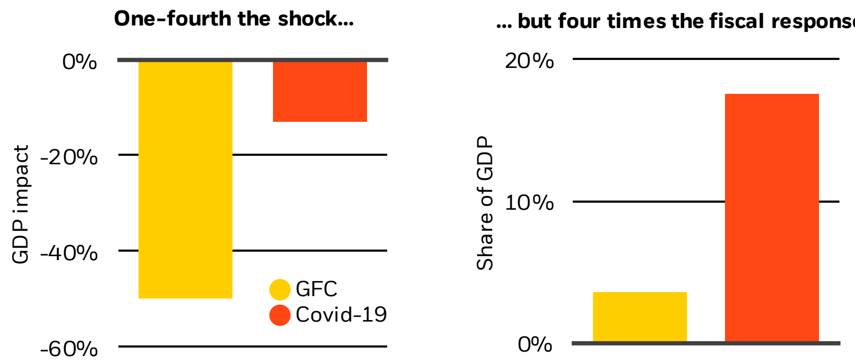
Chart of the week

Estimated U.S. cumulative GDP loss and fiscal support, GFC vs. Covid



Sources: BlackRock Investment Institute and the International Monetary Fund, with data from Haver Analytics, February 2021. Notes: The orange bars show the discretionary fiscal boost following the GFC and Covid shocks. The GFC measure is captured by the change in the cyclically adjusted budget deficit in 2008 and 2009 calculated by the IMF. We use broker estimates of discretionary fiscal measures explicitly introduced in response to Covid for 2020-21. The yellow bars show the cumulative sum of the difference between actual U.S. GDP and where it would have been had it grown at its pre-shock trend rate prior to the Covid-19 shock and the GFC, based on the Refinitiv poll of economists on Jan. 22.

The policy revolution to cushion the Covid shock has driven a record surge in public debt. This is a huge fiscal impulse on its own – but even more so relative to the size and the nature of the shock. We assess that the ultimate cumulative economic loss – what we have long held matters most for financial markets – will be roughly a quarter of that seen after the global financial crisis (GFC). Yet the discretionary fiscal response today is about four times larger, we estimate. See the chart above. Not only is the policy response this time far more overwhelming, but a large part of economic activity will restart on its own once the pandemic is under control, in our view. This is a key difference with the GFC. The objective of the current policy response has been different: it is not to stimulate growth, but to provide a bridge to the post-Covid world. Policymakers, academics, taxpayers and markets have been surprisingly relaxed about the large increase in debt – also a stark contrast to the aftermath of the GFC, when the focus shifted to austerity.

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Record-low debt servicing costs help explain more relaxed attitudes to high public debt levels. Public debt in the U.S. is set to reach a record 135% of GDP, according to IMF forecasts. This is twice as high as in the 1990s, but financing costs are only half what they were then. How long will the tolerance of high debt – and the low-yield regime – last? For now we see the *new nominal* theme in play: a more muted response in nominal government bond yields to rising inflation. Central banks have committed to look through above-target inflation for a while. They may find it politically fraught to raise rates, even if inflation starts to look more concerning. The scars from 2013's "taper tantrum," against a backdrop of even higher indebtedness, also create inertia. And if a tantrum were to occur, central banks would quickly be forced to lean against it, in our view. This is why we have conviction the *new nominal* regime will last for some time – and are tactically pro-risk.

We had stressed in 2019 the importance of clear guardrails around the joint monetary/fiscal policy action. Without them it would be politically challenging to put the fiscal genie back in the bottle and allow central banks to rein in inflation. Over time, this could challenge the demand for government bonds as safe and liquid assets. Investors today pay a premium for holding government bonds for these perceived benefits. We don't expect central banks to raise rates any time soon. Yet government bonds' perceived safety could eventually come into question if a narrative took hold that high debt levels and rising inflation make it more risky. Longer-term yields may then start rising as investors demand a greater term premium – the excess yield that compensates them for holding long- over short-term debt. Central banks would initially lean against any yield spikes, in our view, but their ability to sustain such policy would be limited. Issuance of low- or zero-coupon longer term debt – as governments lock in historically low rates – makes bond holders more vulnerable to losses. Example: A one percentage point rise in 30-year German bund yields would spark twice the price loss today than a decade ago, we estimate.

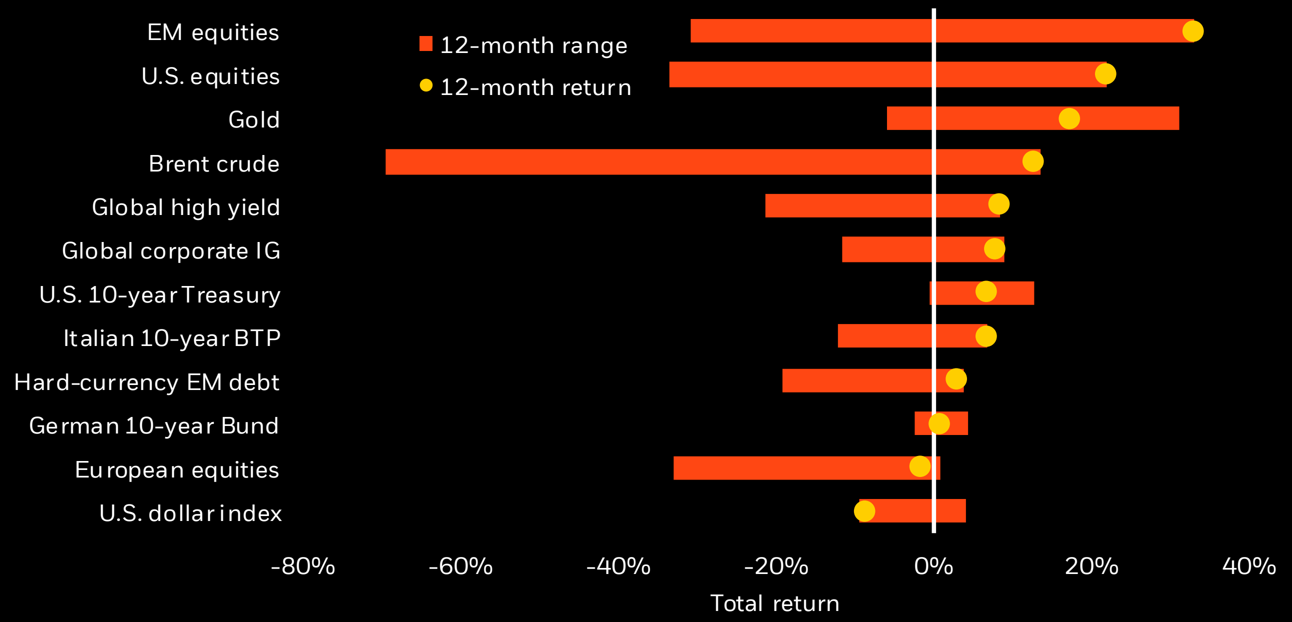
The bottom line: Recent events have strengthened our *new nominal* thesis: real yields have declined even amid the prospect of almost $3 trillion in additional U.S. fiscal support. This supports our pro-risk stance over a tactical horizon. Whether the low-rate regime lasts will depend not only on monetary policy but on the perceived safety of government bonds. Markets may eventually demand a higher premium for government bonds, even if central banks are more tolerant of higher inflation. This, and reduced ballast properties with yields near lower bounds, is why we strategically underweight the asset class.

Market backdrop

U.S. 10-year Treasury yields hit fresh 11-month highs above 1.2% as crude oil prices extended their rally and optimism was running high on the U.S. vaccine rollout and looming stimulus. Treasury yields have been climbing since September, but the magnitude has lagged that of the rise in inflation expectations during the period. Inflation-adjusted yields have been stable in negative territory – in line with our *new nominal* theme. U.S. stocks reached new record highs as global equities saw record weekly inflows.

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, February 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.

Macro insights

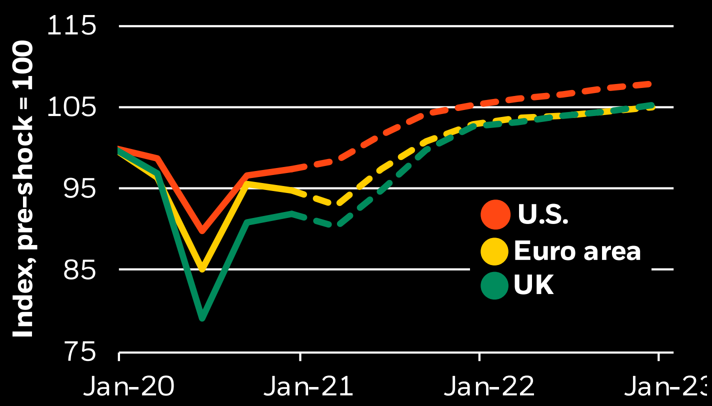
The UK's rapid progress with the Covid-19 vaccine rollout should propel its 2021 restart – with output returning to pre-Covid levels later this year, in our estimates. Yet key service sectors remain vulnerable, and will also have to adjust to structural changes brought on by Brexit. Policy support to prevent permanent scarring will be key.

The hit to services – which make up 80% of UK GDP - partly explains the larger initial hit to the UK. Contact-intensive services especially saw steep declines in output. Renewed lockdown measures have reversed some of the progress made when the economy opened up briefly last year.

We still see the cumulative loss in UK GDP over time to be just under 25% of pre-shock levels – compared to a 43% loss in the wake of the global financial crisis. Underpinning this estimate is the outlook for the virus dynamics that shapes the pace at which economies can reopen – coupled with the speed at which pent-up demand can be unleashed. On this score, the UK is rolling out vaccines at a much faster pace than other large developed economies.

Eyeing the restart

Real GDP and projections, 2020-2023



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Haver Analytics, February 2021. Notes: The solid lines show the path of real GDP, indexed to 100 as of the fourth quarter of 2019 – the last full quarter pre-Covid 19. The dotted lines show our projected GDP paths based on our estimates of restriction measures in coming quarters their potential impact on activity.

Investment themes

1 The new nominal

- We see stronger growth and negative 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 real 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.
- 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 negative 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 developments have been incrementally positive over the past 12 months, and investors are well compensated for these risks.
- **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

Feb. 16	Germany's ZEW Indicator of Economic Sentiment
Feb. 17	U.S. industrial production
Feb. 18	Federal Reserve Bank of Philadelphia Manufacturing Business Outlook Survey
Feb. 19	Composite purchasing managers' index for Japan, the UK, euro area and U.S.

Sentiment data in the U.S. and Europe could shed light on the status of the activity restart amid tightened restrictions. The preliminary Philly Fed sentiment data will be key to watch for signs of a manufacturing boost following renewed fiscal policy support. We expect the vaccine-led economic restart to re-accelerate this year as pent-up demand is unleashed.

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.

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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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 a muted response in nominal U.S. yields to rising inflation expectations, and real yields staying in negative territory. This leads us to prefer inflation-linked over nominal government bonds.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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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