Weekly commentary

BlackRock

May 17, 2021

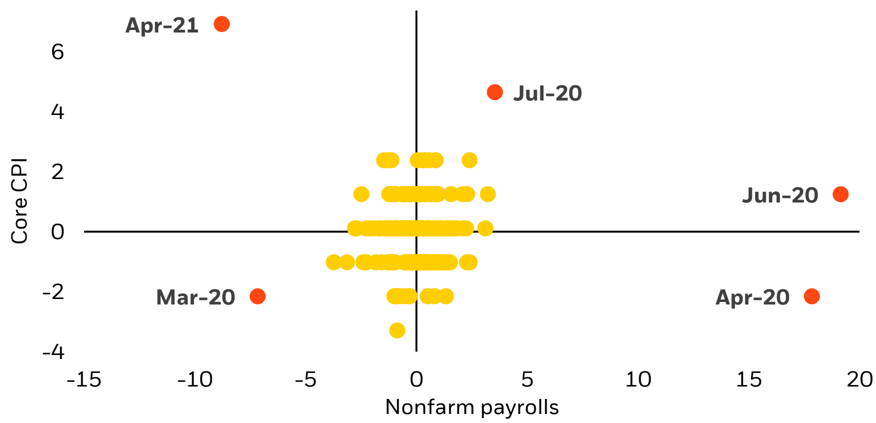
Don't be surprised by surprising data

- We see the recent inflation spike as temporary due to unique restart forces, but see inflation on the rise in the medium term. Both views keep us pro-risk.
- U.S. April inflation was much higher than expected. We have expected noisy inflation data over coming months amid unusual supply/demand dynamics.
- Purchasing managers index (PMI) data for key economies will shed some light on these dynamics, yet investors shouldn't extrapolate too much from it.

Hotter inflation has materialized and market volatility is rising as the economic restart gathers pace. This is playing out in line with our view that the economy is in a "restart" – not a traditional recovery. We prefer to look through any volatility and see a later "lift-off" from zero rates than markets expect. This means higher-than-expected inflation in the medium term, and underpins our pro-risk stance.

Chart of the week

Outsize Covid-19 surprises in U.S. core CPI and nonfarm payrolls



Sources: BlackRock Investment Institute, with data from Bloomberg, May 2021. Notes: Each dot represents the size of forecast error in month-on-month changes in the core consumer price index (CPI) and in nonfarm payrolls, for each month. The forecast error is the gap between realized data and consensus forecasts, and expressed as the number of standard deviations away from the average forecast error. We calculate the mean and standard deviation of forecast errors using monthly data between February 1997 and February 2020 to exclude the volatile pandemic period from the analysis. We use data as they were first reported and do not include subsequent revisions. There is a +121 standard deviation forecast error in the payrolls data in May 2020, and that dot is not shown in the chart.

The ongoing restart features both supply bottlenecks and pent-up demand – different from a typical business cycle recovery where demand typically catches up slowly to supply. Economic forecasters have had a hard time plotting out how these unusual dynamics will play out month to month, causing unusually large surprises on the upside and downside. See the chart above. This is why we need to be humble about our ability to forecast month-by-month dynamics, and to steer away from extrapolating too much from any outsize data surprises as the restart plays out over coming months. We expect supply disruptions to resolve eventually, but uncertainty around the timing could lead to noisy inflation readings – underscored by much higher-than-expected April consumer price index (CPI) data. This is why we recently turned neutral on Treasury Inflation-Protected Securities on a tactical basis, even as we believe markets are still underpricing the potential for above-target inflation in the medium term.

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BlackRock **Investment** Institute

We see inflation trending up over the next few years, but expect inflation and growth data to be erratic in the near term as a unique economic restart takes shape. A look under the hood of April's CPI data showed airfares, lodging and car rental were key drivers of rising inflation, as prices reset to pre-Covid levels. On their own, broad-based inflation pressures from the restart should recede as supply eventually comes back, sector-specific bottlenecks are resolved and the economy fully reopens. How this plays out month to month is highly uncertain. But the current dynamics will not be enough to sustain inflation above target, in our view, which will come instead from a delayed monetary policy response compared to history.

Markets appear primed to seize on any upside surprises to growth and inflation data as implying a more rapid lift-off from zero rates than the Fed policy makers' own projections indicate. We believe near-term data bears very little on the policy rate path. The Fed is operating under a fundamentally different framework, which makes the bar to divert from this policy path very high. Two key developments would likely need to take place before the Fed considers a liftoff. First, the realized core personal consumption expenditures (PCE) price index – the Fed's preferred inflation gauge – stays at or around the central bank's 2% target for a sustained period of more than just a few months. Second, the Fed's inflation projection points to a prolonged period of moderately above-target inflation. Neither of these conditions is close to being met.

As a result, we believe the expectation of a faster lift-off is premature and inconsistent with the Fed's new framework. This implies markets are underappreciating medium-term price pressures that we believe will result from both the Fed's new policy framework as well as higher production costs and higher public debt levels. This keeps us pro-risk in the medium term. We see real, or inflation-adjusted, yields staying low amid rising inflation pressures – and underpinning equities.

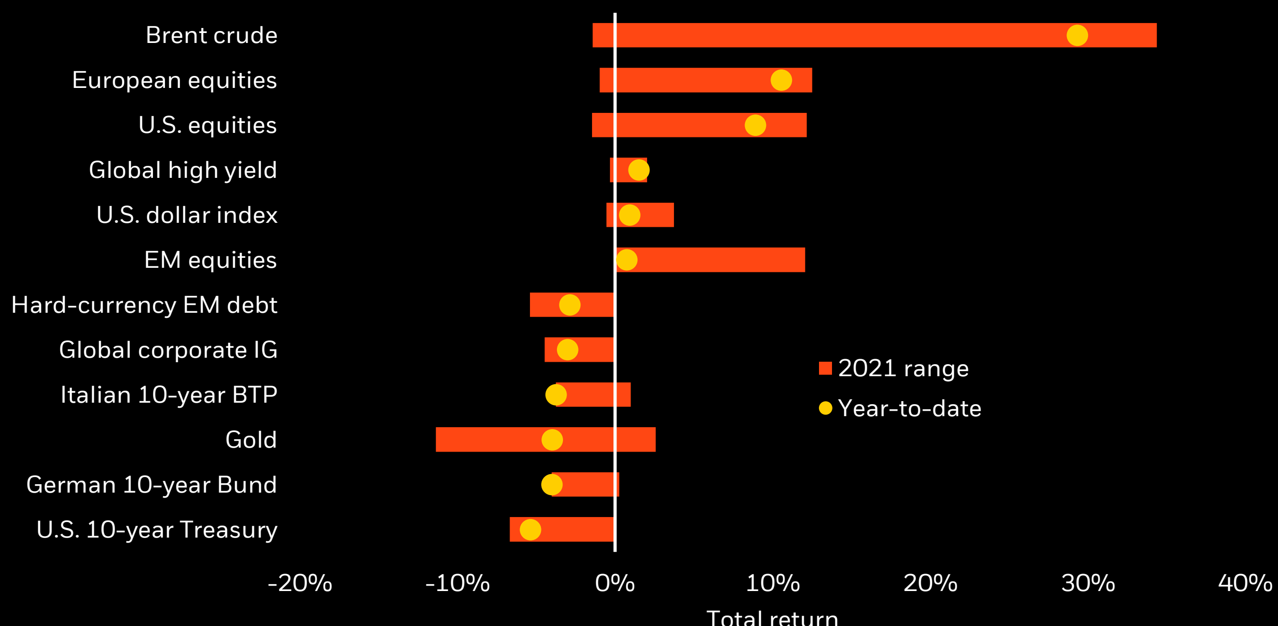
On a tactical horizon, we prefer looking through any near-term volatility and staying invested as the restart broadens out. Our tactical pro-risk view is mainly expressed in overweighting equities and underweighting government bonds. We see two main risks to this stance: first, a market overreaction to the near-term growth rebound and inflation overshoot; and second, a Fed miscommunication of its intent to start tapering asset purchases – or a market misinterpretation of such an announcement. The recent sell-off in tech shares, despite strong first-quarter earnings, illustrates the potential for hitting air pockets as the economic restart unfolds. This may create opportunities in a sector benefiting from structural trends.

Market backdrop

The core U.S. CPI surged to multi-decade highs in April, helping briefly drive down stocks. U.S. 10-year Treasury yields rose but the climb was limited given the inflation surprise, while breakeven inflation rates edged up to new eight-year highs above 2.5%. We have expected market discussion of the Fed's tapering of its asset purchases and eventual policy normalization to trigger market volatility but believe investors should look through such bouts of volatility and stay invested.

Assets in review

Selected asset performance, 2021 year-to-date and range



Past performance is not a reliable indicator of current or 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 Datastream as of May 13, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current 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, in descending order: spot Brent crude, MSCI Europe Index, MSCI USA Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, spot gold, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

Macro insights

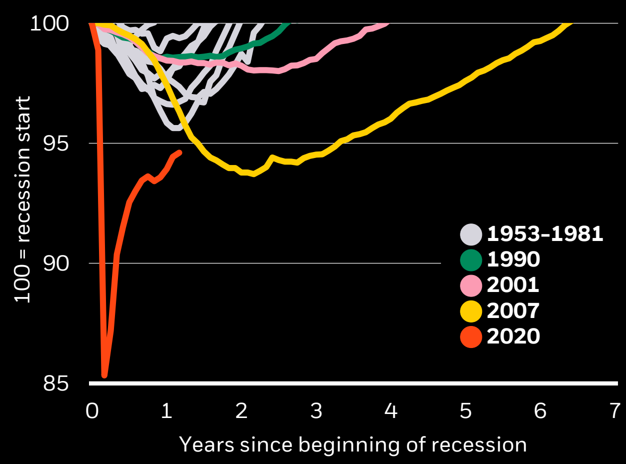
Volatility in recent macro data is a timely reminder why it is important not to confuse the ongoing economic restart with a typical business cycle recovery. April's U.S. employment report was a major miss – with 266,000 new jobs versus a consensus expectation of about 1 million.

We believe our restart framework keeps this data volatility in perspective. Turning large parts of the economy back on has already led to some eye-watering activity growth and inflation rates. Employment plunged as the businesses were brought to a deliberate halt when the Covid-19 shock hit. Payrolls contracted far more quickly than is typical in a business cycle recession. The subsequent labor market restart has been rapid – even if there is still a large gap to make up, as the chart shows.

We see job gains picking up again as the reopening broadens. Yet we see activity and labor market data being less relevant for the Fed – and ultimately for markets. Inflation outcomes and the inflation outlook will matter more for the new Fed policy framework. See our macro insights hub for more.

A restart, not a recovery

U.S. job losses and gains after recessions, 1953-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2021. Notes: The chart shows U.S. payroll losses from recessions, and from the Covid shock, and the time needed to recover from those losses, indexed at 100 at the start of the recession.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart, powered by pent-up demand and sky-high excess savings. The huge growth spurt will be transitory, in our view. This is because a restart is not a recovery: the more activity restarts now, the less there will be to restart later.
- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – was confirmed by the Fed's March economic projections. Fed officials have repeated since that it is too soon to talk about tapering bond purchases. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **Market implication**: We favor inflation-linked bonds amid inflationary pressures in the medium term. Tactically we prefer to take risk in equities over credit amid low rates and tight spreads.

2 Globalization rewired

- Covid-19 has accelerated geopolitical transformations such as a bipolar U.S.-China world order and a rewiring of global supply chains, placing greater weight on resilience.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels and U.S.-China conflicts, but we believe investors are compensated for these risks.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like Asia ex-Japan equities, and see UK equities as an inexpensive, cyclical exposure.

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 strong performance 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 see returns being driven by climate change impacts, and view developed market equities as an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

May 20 Philly Fed manufacturing business outlook survey

May 21 Composite purchasing managers' index (PMI) for Japan, euro area, UK and U.S.; euro area flash consumer confidence

PMI data from key economies this week will shed some light on the unusual supply and demand dynamics amid a powerful restart, though we believe investors should not extrapolate too much from the data. The euro area consumer confidence data could give some hints on any change in the consumer sentiment against the backdrop of accelerating vaccinations.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indexes. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a bias for quality.
Credit	-1	Neutral	We are underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, credit, especially investment grade, has come under pressure from tightening spreads, but we still like high yield for income.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and rising debt levels may eventually pose risks to the low-rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. We are underweight duration on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart.
Cash		Neutral	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.
Private markets	Neutral		We believe 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.

Notes: Views are from a U.S. dollar perspective, May 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, May 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 neutral European equities. We believe the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
	Japan	■		We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a 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 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.
	UK		■	We are overweight UK equities. The removal of uncertainty over a Brexit deal should see the risk premium on UK assets attached to that outcome erode. We also see UK large-caps as a relatively attractive play on the global cyclical recovery as it has lagged peers.
	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 recent underperformance. 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 turn neutral min vol. Our regional and sectoral preferences warrant a higher exposure to the factor. Min vol's underperformance has brought valuations to more reasonable levels in our view.
	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 may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries	■		We are underweight U.S. Treasuries. The accelerated economic restart has sent yields surging, but we prefer to stay underweight as we expect short-term rates will stay anchored near zero.
	Treasury Inflation-Protected Securities			We are neutral TIPS after the sharp rise in inflation expectations since late year. Further increases seem unlikely in the near-term. We still see inflation pressures building over the medium term due to structural reasons.
	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 neutral euro peripheral bond markets. Yields have rallied to near record lows and spreads have narrowed. The ECB supports the market but it is not price-agnostic - its purchases have eased as spreads have narrowed.
	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 overweight EM local debt as its year-to-date underperformance has left valuations more appealing, particularly if U.S. Treasury yields and the U.S. dollar stabilize. We see limited contagion to broader EM from selected country-specific volatility.
	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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