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Weekly commentary

June 21, 2021

BlackRock

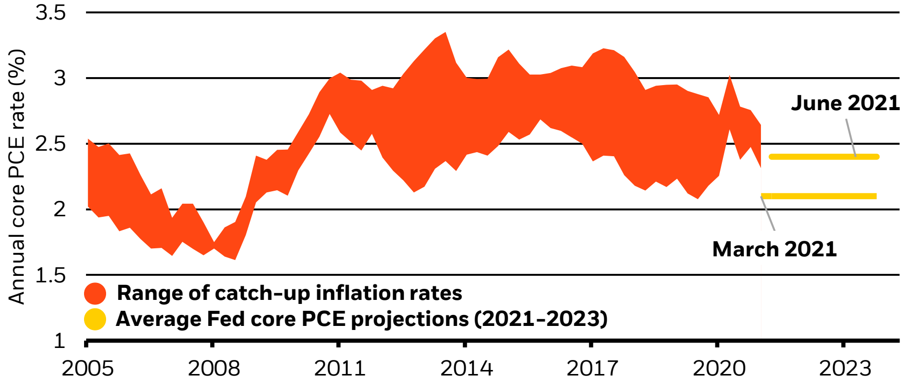
Fed catches up with restart reality

- Fed officials embraced higher 2021 inflation as contributing to their medium-term policy objective, opening the door to a 2023 lift-off.
- We see this shift as consistent with the Fed's new framework, implying a much more muted response to inflation and supporting risk assets.
- Global purchasing managers' index (PMI) and other sentiment data this week will help investors gauge the status of the economic restart.

The Fed surprised markets by embracing higher inflation and heralding a lift-off from zero rates in 2023, rather than 2024. We think this could add to its new framework's credibility as long as last week's fall in inflation expectations does not persist. Ultimately, the Fed's outlook implies a more muted response to rising inflation than in the past. This and the economic restart keep us pro-risk.

Chart of the week

Average Fed inflation projections vs. catch-up inflation rates, 2005-2023



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and Federal Reserve, June 2021. Notes: The chart shows the range of actual core personal consumption expenditures (PCE) inflation levels that would be needed to make up for past undershoots of the Fed's 2% target based on looking back at windows over the previous two and five years. The median projections for core PCE inflation for Q4 of 2021, 2022 and 2023 from the Fed's Summary of Economic Projections (SEP) were 2.2, 2 and 2.1 respectively in March, and 3.0, 2.1 and 2.1 in June. The yellow lines represent the average of those projections in March and June.

The Fed has now made a meaningful upgrade to its inflation outlook by embracing a more pronounced overshoot of its 2% target. We view this upgrade as the Fed catching up with the restart dynamics. While the upgrade largely reflects the incoming data since the last meeting, there is a notable change: The Fed now sees the ongoing inflation surge as contributing to achieving its objective as opposed to focusing on its transitory nature. In addition, Fed officials now view the risks to their inflation outlook as having shifted to the upside. Even with the upgrade, their latest average inflation projection for the next three years only just sits at the bottom of the range of what could be argued to amount to a defendable make-up for past inflation undershoots. See the chart above. This new outlook opens the door to a 2023 liftoff in policy rates, something that was not possible under its March inflation outlook. This is still a much more muted response to inflation pressure than under its previous framework – or other major central banks' current frameworks, in our view. It makes for a unique environment - we have called it the *New nominal* – that we see playing out in the next few years.

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Some market participants have suggested the Fed's shift to acknowledge higher inflation and pull forward its rate hike projections is evidence that it is already retreating from its new framework. We don't think that's the case. Instead, we view it as a reflection of more positive longer-term dynamics. The inflation outlook upgrade can now be argued to support a meaningful make-up of past misses, as the chart shows. This gives greater credibility to the Fed's current policy stance in the context of its new framework. But it's a minimum requirement. The new framework implies that if inflation falls short of the Fed's projections – which are just at the lower end of the catch-up rates – the Fed might have to delay lift-off. The credibility of the Fed's new framework could become challenged if last week's downward move in inflation expectations were to persist. Overall, we see the new guidance as more balanced, with meaningful risks on both sides.

We had expected a 2023 liftoff, and the Fed now projects two increases that year – versus no liftoff projected in March. Yet markets are getting ahead of themselves by baking in three rate increases by the end of 2023, as indicated by the pricing of futures tied to the cost of overnight borrowing, in our view. We believe there is a limit to how much more hawkish the Fed can be given its inflation projections relative to the catch-up rates range. If expectations for a much earlier lift-off were to take hold, that would call into question the credibility of the Fed's new framework and could lead to broader risk-off sentiment. The Fed has flagged it will start to assess the economy's progress meeting by meeting, and this means more "live" discussion on the tapering of its asset purchases. We would not view taper discussions as a signal that the liftoff is getting closer, yet there is a risk such discussions could trigger market volatility or be miscommunicated by the Fed.

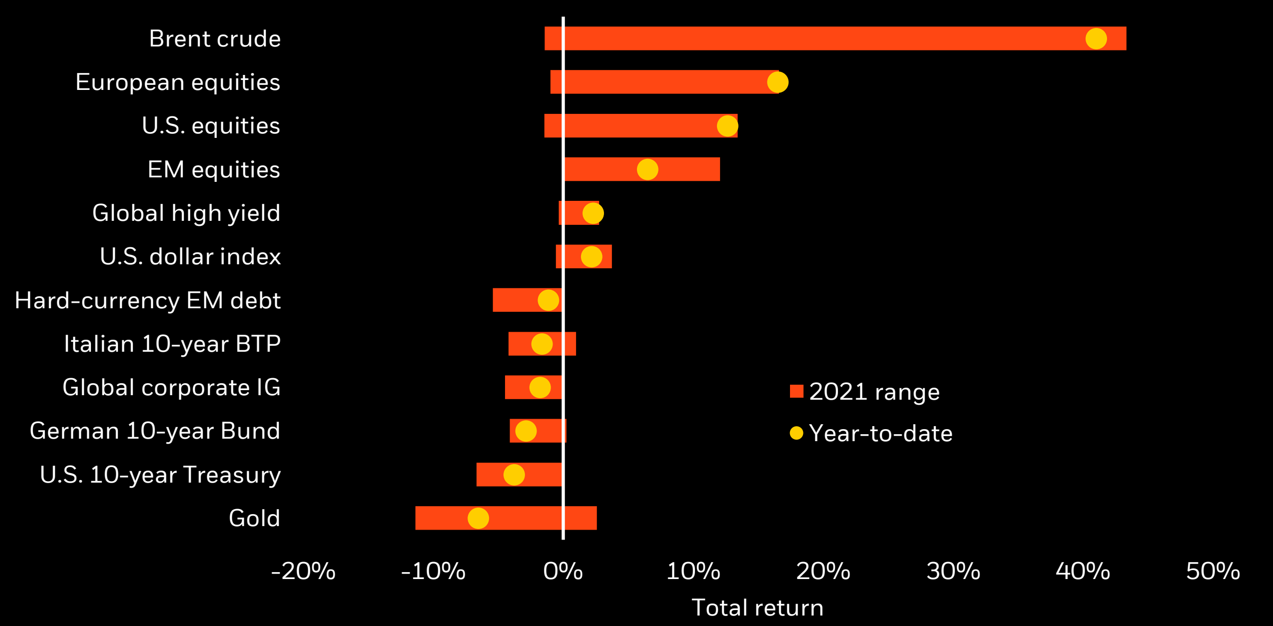
Our bottom line: We believe the Fed's new outlook will not translate into significantly higher policy rates any time soon. This, combined with the powerful restart, underpins our pro-risk stance. Large cash balances held by investors and no obvious signs of financial vulnerabilities give us additional confidence. We prefer to take risk in equities and remain underweight bonds on valuations. Within equities, we have been warming up to cyclical stocks as the restart broadens globally, as reflected in an overweight call on UK equities and our upgrading of European equities to neutral earlier this year. We may see bouts of market volatility as markets test the Fed's resolve to stay "behind the curve" on inflation. Any temporary spikes in rates could challenge emerging market assets in particular, but we advocate staying invested and looking through any turbulence as the *New nominal* plays out.

Market backdrop

Federal Reserve officials moved up their projections for raising interest rates, with the median expecting the first rate increase to take place in 2023, instead of 2024 in previous projections. U.S. bond yields rose and stocks softened. Economic data have been erratic, and we expect more of the same as economies restart amid pent-up consumer demand and supply shortages. We advocate looking through near-term market volatility and remain pro-risk, predicated on our belief that the Fed faces a very high bar to change its easy monetary policy stance.

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 June 17, 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, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), spot gold, J.P. Morgan EMBI index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

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Macro insights

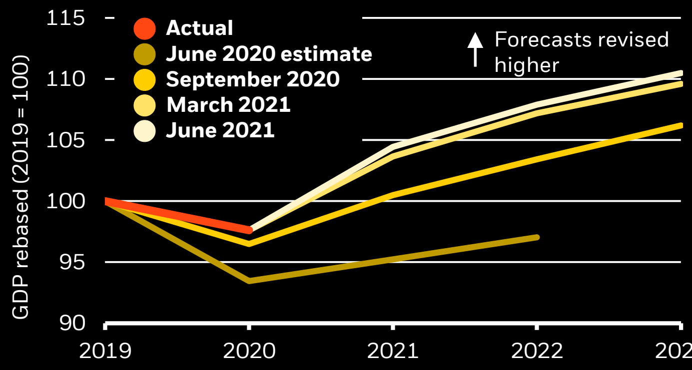
The economic restart in the U.S. is outpacing expectations. The Fed has repeatedly revised its growth estimates for GDP upwards over the past 12 months to considerably higher than original estimates In its latest projection, GDP is expected to surpass pre-Covid levels this year, rather than taking several years as initially expected.

In contrast, growth forecasts were repeatedly revised down after the global financial crisis. This underscores the different nature of the Covid shock: We view it as more akin to a natural disaster than a typical business cycle downturn.

Yet the upward revisions are becoming smaller as the restart plays out, as shown in the chart. The Fed's indication last week that rate hikes could potentially come earlier than previously forecast were in response to the inflation outlook - and not upward revisions to growth, in our view. We believe the Fed will also pay close attention to the labor market, and monitor how quickly the restart translates into broad employment gains. See our macro insights hub.

A strong restart

Actual annual U.S. GDP and Fed estimates post-Covid shock



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, Federal Reserve, and Reuters News, with data from Haver Analytics, June 2021. The chart shows the level and estimates of U.S. GDP over time for the Covid-19 shock, rebased to 100 for the year prior to the shock – 2019. Estimates are from the Fed's Federal Open Markets Committee's Summary of Economic Projections published through 2020-21. The level of GDP is derived from the FOMC's forecasts of GDP growth from the fourth quarter of the prior year to the fourth quarter of the current year. Early estimates are as of June 2020, later estimates as of June 2021.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart – with the euro area catching up - 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.
- Fed officials in June projected higher inflation and moved up the lift-off in policy rates to 2023. We believe this confirmed our *new nominal* theme – that interest rates will rise more slowly than in the past in response to higher inflation – as the Fed's acknowledgement of rising price pressures has not translated into projections for significantly higher interest rates any time soon.
- We believe the rise in nominal government bond yields this year is justified and reflects markets awakening to a strong, vaccine-driven activity restart combined with historically large fiscal stimulus.
- 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. Pending legislation in the U.S. would direct large-scale investment to meet the China challenge. We see a case for greater exposure to China-related assets for potential returns and diversification – and view them as core strategic holdings that are distinct from EM exposures.
- 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.
- Momentum is growing at the G20 for a global minimum tax that would reduce the ability of multinationals to shift profits to low-tax jurisdictions.
- **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. We see a risk of social unrest.
- **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.

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Week ahead

June 22	Philly Fed nonmanufacturing business outlook survey	**June 24**	Bank of England policy meeting; German ifo Business Climate Index
June 23	Flash composite PMI for Japan, the euro area, UK and U.S.	**June 25**	U.S. personal income and outlays

Global PMI and other sentiment data will help investors gauge the status of the economic restart. The restart has been broadening out thanks to accelerated vaccinations. It has also created both supply bottlenecks and pent-up consumer demand, leading to volatile near-term inflation and growth data especially in the U.S.

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.

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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, 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.
Equities	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.
Equities	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.
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	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.
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 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 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.
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 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.
Fixed Income	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.
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 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.
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 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.
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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