Weekly commentary

August 2, 2021

BlackRock

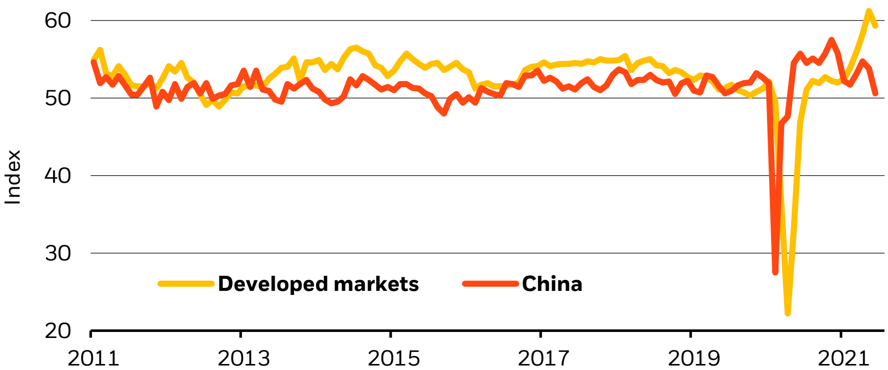
Taking stock on China

- We see China's regulatory crackdown that recently rattled markets likely to moderate, alongside a dovish shift in macro policy, for the near term.
- The Federal Reserve noted further progress in the economy as expected; we see a tapering of asset purchases unlikely to start before early next year.
- U.S. nonfarm payrolls will be in focus, with consensus forecast expecting a faster pace of growth than June when jobs gain was the largest in 10 months.

China's regulatory clampdown on industries such as tutoring and tech has unnerved global investors. We see little global spillover risk from China's assertion of greater control over certain industries, even as it potentially leads to market volatility. We remain tactically neutral on China stocks and see further monetary and fiscal policy loosening as beneficial for cyclical assets in China.

Slower activity

China and developed markets composite PMI, 2011-2021



Sources: BlackRock Investment Institute, with data from Markit Economics, July 2021. Notes: The yellow line represents the monthly Markit purchasing managers' index (PMI) of developed markets, including Australia, Austria, Canada, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, Netherlands, Singapore, South Korea, Spain, Taiwan, the UK and U.S. The orange line shows the monthly Caixin China composite PMI.

We see last week's developments in line with China's long-term hawkish macro policy stance and regulatory clampdown as the country pursues quality growth. This process is not a straight line, and we see a dovish shift in the near term as economic growth has been losing momentum.

China's economy returned to its pre-pandemic growth trend in late 2020, but has shown signs of slowing in recent months. China's Caixin composite purchasing managers' index (PMI) has dipped from a peak of 57.5 in late 2020 to near 50 in June – still in expansionary territory but below the level seen in developed markets. See the chart above.

Against this backdrop, Chinese authorities have started a dovish shift in near-term monetary and fiscal policy, and we expect them to moderate the pace of the regulatory tightening that has recently rattled markets.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Yu Song
Chief China Economist – BlackRock Investment Institute

Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

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

BlackRock **Investment** Institute

The Politburo of the Chinese Communist Party, which is made up of the country's most senior leaders, held a key policy meeting last week. It recognized downside risks on growth and the need to cushion these risks by pre-emptively easing its policy stance. We expect China's broad-based, macro policy stance to loosen further during the rest of the year –including monetary, fiscal and some administrative aspects, and see cyclical assets potentially benefitting. Yet we expect a measured approach from policymakers. The Politburo's meeting statement struck a slightly dovish tone on regulatory policy, and we see this as a reflection of the pragmatism of China's leadership after recent regulatory moves led to market volatility.

This does not imply a fundamental shift in the regulatory policy stance, in our view. We believe the regulatory clampdown will likely go on for years, yet its intensity will fluctuate. China's leadership sees regulatory tightening in sectors such as tutoring and technology as necessary to rein in the industries that have been rapidly growing and lightly regulated, which has led to concerns about control of data, inequality, and the rising costs of education, housing and healthcare, in our view.

Keeping tabs on Chinese policy priorities will be key. Our take: Chinese authorities will likely balance their regulatory agenda against a desire for economic stability, and the intensity of the regulatory crackdown may ease amid slower growth and market volatility. Yet Beijing's targeted regulatory actions may still inadvertently trigger episodic market volatility, as witnessed in recent weeks. China's policymakers are loosening policy for the near term, but we expect them to stick to a medium-term hawkish stance – key to Beijing's effort to focus on the quality of growth. Uncertainties around Beijing's hardened stance on selected sectors – not growth concerns – were the main reason for recent market anxiety, in our view. We expect the regulatory clampdown to continue, but its pace and intensity may moderate as policymakers weigh its impact on growth and markets.

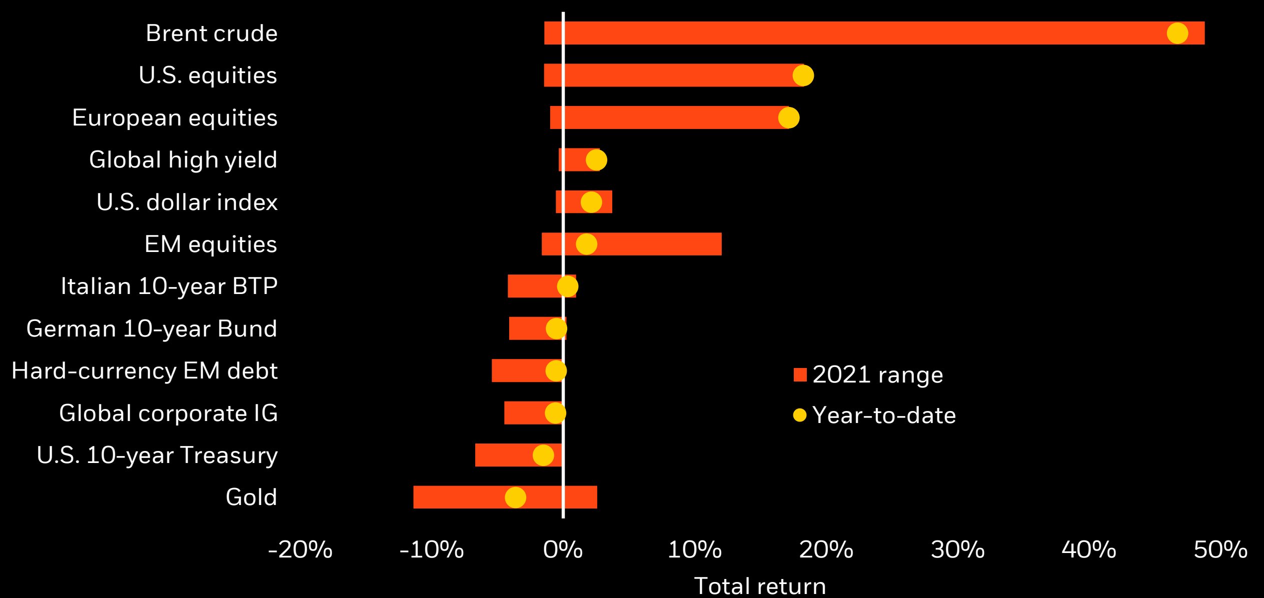
The bottom line: We remain neutral on Chinese equities tactically, but are seeing opportunities emerge in sectors that benefit from monetary easing or are less prone to regulatory tightening. We stand by our strategic preference for Chinese assets. The case for Chinese government bonds in particular is undimmed, in our view, and remains a key strategic overweight in a low-yield world. We recognize implementation of our asset views will differ across investor types and geographies, depending on objectives, constraints and regulation.

Market backdrop

The Fed as expected acknowledged further progress toward its goals but still sees some way to go before it can begin talking about a tapering of asset purchases. We see tapering unlikely to start before early next year given the Fed's intention to provide ample notice. The U.S. Senate voted to advance a nearly $1 trillion infrastructure bill that delivers $550 billion in incremental new funding for public transit, roads and bridges, and other physical infrastructure.

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 July 29, 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 USA Index, MSCI Europe Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

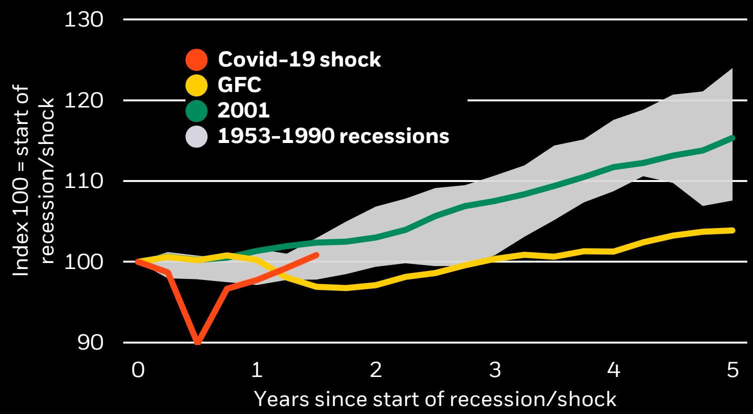
The U.S. economy grew slightly faster in the second quarter than in the previous quarter, but below the consensus forecast. U.S. GDP, which grew at an estimated 6.5% pace in Q2, is projected to have now surpassed its pre-pandemic level, meaning the overall GDP shortfall will be only a fraction of that of the global financial crisis (GFC). See the chart.

We see this as further confirmation that we are witnessing a restart, not a typical business cycle recovery – and any misses of expectations should be understood in that context. A look under the hood reveals clear restart dynamics: services activity was resuming and consumer spending actually exceeded expectations, growing by nearly 12% on the year.

The rapid restart puts us in a very different position compared with after the GFC. Fiscal stimulus and easy monetary policy have provided a bridge through the pandemic, avoiding a long, sluggish recovery and permanent hit to growth like we saw after the GFC. Under its new framework, we see the Fed unwinding the ample monetary accommodation much more slowly than in the past. See our macro insights hub.

Restart, not a recovery

U.S. GDP over Covid shock and past recessions



Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Economic Analysis and the National Bureau of Economic Research (NBER), July 2021. Notes: The chart shows the level of U.S. GDP during recessions since 1953. The level of GDP is indexed to 100 in the quarter prior to the start of each recession, using the NBER definition of U.S. business cycles and expansions. The Covid-19 shock is shown in orange, the global financial crisis in yellow and 2001 recession in green, and the gray swathe shows the range of GDP levels reached at each subsequent quarter after the recession starts over the recessions between 1953 and 1990.

Investment themes

1 The new nominal

- The powerful economic restart is broadening, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- We expect the Fed to start normalizing policy rates in 2023, a much slower pace than market pricing for lift-off in 2022 indicates. The market's lack of confidence in the Fed's commitment to its new framework poses a risk of tighter financial conditions in the near term. We would anticipate this uncertainty to dissipate over time – assuming the central bank regains control of its narrative – paving the way for us to lean even more tactically pro-risk.
- The ECB tweaked its forward guidance after having recently set its inflation target at 2% in the medium term but rejecting an average inflation targeting framework. The central bank said it would keep policy rates on hold until it had seen "inflation reaching 2% well ahead of the end of the projection horizon and durably for the rest of the projection horizon." We see this likely to be followed by an increase in the ECB's asset purchases later this year.
- **Tactical implication**: We go overweight European equities and inflation-linked bonds. We cut U.S. equities to neutral.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is already a distinct pole of global growth. We believe it is time to also treat it as an investment destination separate from EM and DM.
- Chinese authorities have started loosening policies as growth slows, yet we believe they will maintain the broadly hawkish policy stance over the medium term to stay focused on the quality of the growth.
- We believe the clampdown on some private industries could go on for years, but its intensity would likely fluctuate. We have yet to see the peak of the regulatory campaign, but could see it pace and intensity to moderate amid slower growth.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We break out China from EM with a neutral stance on equities and an overweight to debt.
- **Strategic implication:** Our neutral allocation to Chinese assets is multiples larger than typical benchmark weights.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of prices of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

August 2	U.S., China, euro area, UK, Japan manufacturing PMI
August 4	U.S., China, UK, Japan services PMI; euro area composite PMI
August 5	Bank of England monetary policy decision
August 6	U.S. nonfarm payrolls

U.S. nonfarm payrolls data will be in focus. Consensus forecast expected an increase of 900,000 jobs in July, according to Refinitiv, after posting the largest monthly gain in June on the back of a strong growth in services sector.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our 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 indices. 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 quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballast with yields near lower bounds. 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 – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
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 and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, July 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, July 2021

	Asset	Underweight	Overweight	
Equities	United States			We turn neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
	Europe			We upgrade European equities to overweight on the back of the broadening restart. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
	UK			We turn neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
	Japan			We upgrade Japanese equities to neutral. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
	China			While overweight on a strategic basis, we see near-term risks. Growth is slowing at the same time as policy stance is tight – and may not respond in a timely way as authorities focus on the quality of growth. The anti-monopoly clampdown is ongoing.
	Emerging markets			We downgrade EM equities to neutral. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
	Asia ex-Japan			We downgrade Asia ex-Japan equities to neutral. The anti-monopoly clampdown in the heavyweight Chinese tech sector and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We add to our underweight on U.S. Treasuries, primarily on valuations. We see the balance of risks tilting toward gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
	Treasury Inflation-Protected Securities			We turn overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
	China government bonds			We initiate a view on Chinese government bonds with an overweight. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
	Global investment grade			We remain underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
	Global high yield			We downgrade high yield to neutral after the asset class' strong performance. Spreads are now below where we see high yield as attractively valued. We prefer to take risk in equities.
	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 downgrade to neutral and see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring, in our view.
	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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.