Weekly commentary

Nov. 2, 2020

BlackRock

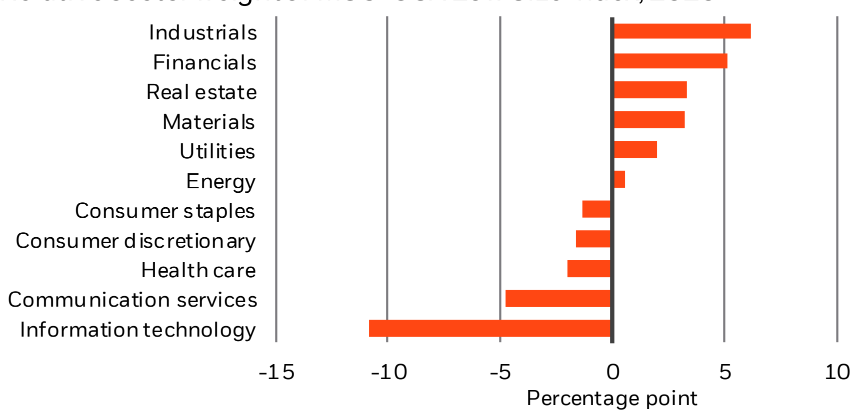
Our latest equity views

- We update our equity views ahead of the U.S. election, including upgrading emerging market equities and introducing an overweight in the size style factor.
- A resurgence of Covid-19 cases may weigh on mobility and activity in the near term. We still see this wave of infections as shallower than the spring one.
- Democratic nominee and former Vice President Joe Biden retains his lead in national polls as the U.S. nears Election Day.

Polls are suggesting a greater likelihood of a Democratic sweep in this week's U.S. election. We are starting to incorporate themes we believe would outperform in that event, moving toward a more pro-risk stance overall despite last week's market pullback. We debut an overweight in the U.S. size style factor, and upgrade broad emerging market (EM) and Asia ex-Japan equities to overweight.

Chart of the week

Relative sector weight of MSCI USA Low Size Index, 2020



Sources: BlackRock Investment Institute and MSCI, data as of Sept. 30, 2020. Notes: The bars show the weights of sectors on the MSCI USA Low Size Index minus those on the parent MSCI USA Index.

Large-cap technology stocks have driven U.S. equity market performance this year. We believe a repeat is unlikely in 2021, and see potential for smaller companies to outperform, especially in the case of a Democratic sweep that would result in significant fiscal stimulus. This electoral outcome also would likely lead to a new global minimum tax and more strenuous anti-trust review – which could weigh on large-cap tech and pharmaceutical companies. A boost in infrastructure spending could lend support to companies in industrials and materials – many of them small in size. We introduce an overweight in the size style factor in the U.S. market to capture our preference for smaller, high-growth companies. The chart above illustrates what underpins our view: The MSCI USA Low Size Index has a much higher share of industrials – and much lower exposure to information technology and communication services – than the parent MSCI USA Index. Meanwhile we downgrade minimum volatility to underweight, as we expect a cyclical upswing over the next six to 12 months – an environment where min vol typically lags in performance. This comes as U.S. earnings reports for the third quarter have beaten expectations.

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We are also updating some of our regional equity market views. This includes upgrading broad EM equities to overweight. Positive spillovers to global growth from increased fiscal stimulus, more predictable U.S. trade and foreign policy and the prospect of a weaker dollar amid negative U.S. real rates in the event of a Democratic sweep would all bode well for EM assets, we believe. We also downgrade Japanese equities to underweight. That said, we are not outright negative on this market. We just expect Japanese stocks to benefit less than other Asian markets and EM in general from a recovery in global trade: A weaker dollar could send the Japanese yen up, putting pressure on the country's export sector.

The evolving virus dynamics are another key factor. We are upgrading Asia ex-Japan equities and Asia fixed income to overweight, as China and other Asian economies have done a better job of containing Covid – and are further ahead in the economic restart. We expect this dynamic to continue over the months ahead. We are downgrading European equities to neutral. A resurgence in Covid cases has triggered lockdowns on local and national levels – albeit with more flexibility than earlier in the year – just as the economic restart shows signs of weakness. The renewed restrictions are already putting pressure on activity in the region. We still like euro area peripheral bonds due to the European Central Bank's easing stance.

The bottom line: We are taking another step toward a pro-risk stance despite last week's market pullback and the uncertainties just ahead. This follows our tactical move last week to downgrade U.S. Treasuries and upgrade their inflation-linked peers on a growing likelihood of significant fiscal expansion. A Democratic sweep outcome in the election would tip us to a more pro-risk stance overall, strengthening our conviction that a cyclical upswing will benefit risk assets over a 6-12 month horizon.

The key risk to our view: There is a material probability of an election outcome that would deliver much less fiscal stimulus. That's why our moves to a pro-risk stance have been partial to date and granular in nature. There is also a chance of a contested election, but we believe there are mechanisms for resolving this. We prefer to look through any market volatility that a delayed result would likely bring and favor taking advantage of any selloffs in risk assets during this period of uncertainty to add to high-conviction positions. See our U.S. elections primer for key election scenarios and investment implications.

Market backdrop

The current wave of Covid infections is still smaller than that of March and April, after adjusting for the increased testing capacity today. Yet an acceleration in hospitalization rates has triggered restrictions on local and national levels in Europe, though they are less stringent than during the initial wave. The economic restart has been quicker than expected, but the economic restart looks to face significant challenges in the near term. All eyes are on the U.S. election given the significant policy and market implications.

Assets in review

Selected asset performance, 2020 year-to-date and range

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, October 2020. 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: 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.

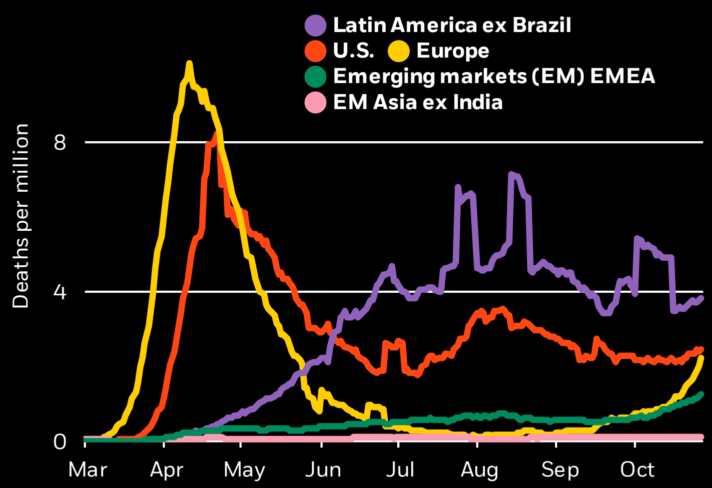
Macro insights

The hit from Covid-19 – and the outlook for economic recovery – varies widely across EMs. The disparity in the number of deaths is especially stark. Latin America has suffered more greatly than Asia. See the chart.

China is the only country expected to have positive GDP growth in 2020, according to the International Monetary Fund. Production and exports have rebounded in South Korea and Taiwan. Yet the outlook is less optimistic in other countries. For example, activity in India well below its pre-Covid levels. EM economies also vary in their ability to mobilize policy to bridge income gaps. Concerns around long-term monetary and financial stability have limited policy space. Inflation pressures could hinder the scope for further easing, alongside weaker currencies. This is most acute in Latin America and Turkey. EM debt to GDP ratios could reach the highest levels in the past 30 years, the IMF says, exceeding 100% in Brazil. Yet as long as U.S. monetary policy remains accommodative, the risk of an abrupt tightening in financial conditions remains low.

Stark divergence within EM

Regional daily new Covid-19 deaths per capita



Sources: BlackRock Investment Institute and the European Centre for Disease Prevention and Control, Oct. 2020. Notes: The chart shows daily new Covid-19 deaths for each country or region.

Investment themes

1 Activity restart

- The activity restart is moving into a more difficult phase just as a flare-up of coronavirus infections prompts tighter restrictions. The initial phase of the economic restart has been quicker than expected, as reflected by the IMF's recent upgrade to its global growth outlook. We see the hardest part lying ahead.
- The sharp rise in Covid hospitalization rates in Europe has led to restrictions on local and national levels – albeit not as stringent as in the spring. The current wave is still smaller than the initial one, correcting for more testing. The next few weeks will be key in containing the virus – and in determining if more restrictions will be needed.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-Covid world could be painful, especially for contact-intensive sectors if mobility is curtailed for an extended period of time.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both a strategic and tactical horizon. We are tactically overweight broad EM, Asia ex-Japan equities and the size style factor in the U.S., and have closed our overweight in European equities.

2 Policy revolution

- The joint fiscal-monetary coordination in response to the Covid-19 shock is nothing short of a policy revolution. The Federal Reserve is leading major central banks in evolving policy frameworks to explicitly aim to let inflation overshoot targets – a desirable move in the current environment but the lack of proper guardrails raise concerns.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows. Yet the recent surge in Covid cases is driving up the need for further policy support.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus. The likelihood of additional fiscal stimulus before a new Congress is seated in early 2021 looks to be dwindling. The European Central Bank has committed to take new action in its December policy meeting.
- Europe's historic recovery fund will introduce mutualized debt and create jointly issued European bonds that can compete with other perceived safe-haven assets. It still needs approvals by the European and national parliaments.
- The blurring of monetary and fiscal policy means that it is crucial to have proper guardrails around policy coordination. In their absence we see a risk that major central banks could lose grip of inflation expectations relative to their target levels. Combined with other structural changes accelerated by Covid such as deglobalization, it could lead to a higher inflation regime in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on both strategic and tactical horizons. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions in technology stocks.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We see countries, sectors and companies making a comeback as potential diversifiers in a fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. We believe investors should consider alternative return sources that can provide potential diversification.
- A focus on sustainability makes portfolios more resilient, in our view. We believe the adoption of sustainable investing is a tectonic shift carrying a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer sustainable assets, private markets and deliberate country diversification on a strategic basis. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops.

Week ahead

Nov. 2	IHS Markit manufacturing purchasing managers' index (PMI) for China (Caixin),Japan euro area, the U.S.	**Nov. 5**	Federal Open Market Committee meeting; Bank of England policy meeting
Nov. 3	U.S. election	**Nov. 6**	U.S. nonfarm payrolls

All eyes are on the U.S. election this week. Democratic nominee and former Vice President Joe Biden has held a steady lead in national polls over President Donald Trump, though in battleground states his lead is narrower. The outcome of the election will have significant implications for policies and markets. Read our election primer here (LINK).

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2020

Asset	Strategic view	Tactical view	
Equities	**Neutral**	**Neutral**	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall. We like the quality factor for its resilience and favor Europe among 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 strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
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 unprecedented policy accommodation suppresses yields.
Cash		**Neutral**	We are neutral on cash. Holding some cash makes sense, in our view, as a buffer against 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. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures but valuations and inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, November 2020. 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, November 2020

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. Risk of fading fiscal stimulus and an extended epidemic weigh on markets. Renewed U.S.-China tensions and a divisive election also weigh.
	Euro area			We downgrade European equities to neutral. Covid cases have surged just as the economic restart appears to be losing steam. Renewed restrictions are weighing on activity.
	Japan			We downgrade Japanese equities to underweight. A weaker dollar may be reflected in a stronger yen, weighing on Japanese exporters. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy.
	Emerging markets			We upgrade broad EM equities to overweight on rising probability of a Democratic sweep outcome, as a large fiscal spending, more stable foreign policy, a weaker dollar and negative real rates would benefit EM assets.
	Asia ex-Japan			We upgrade Asia ex-Japan equities to overweight. China and a number of other Asian countries have done a better job of containing the virus – and are further ahead on the road to economic recovery.
	Momentum			We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold.
	Value			We are neutral on value. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance.
	Minimum volatility			We downgrade min vol to underweight. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
	Quality			We reduce our overweight on quality by a notch as the election could lead to a cyclical expansion where quality appears less attractive. We see it as resilient against a range of outcomes in the pandemic and economy.
	Size			We debut size, a new addition to our style factor lineup, at overweight. Small- and mid-cap companies in the U.S. are set to benefit from fiscal expansion under a potential Democratic sweep.
Fixed Income	U.S. Treasuries			We downgrade U.S. Treasuries to underweight. The potential for fiscal spending – particularly in a Democratic sweep election outcome – could spur higher yields and a steeper yield curve.
	Treasury Inflation-Protected Securities			We upgrade TIPS to overweight. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy, greater fiscal stimulus and increasing production costs.
	German bunds			We upgrade bunds to neutral. 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 outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions.
	Global investment grade			We hold investment grade credit at neutral. We see little room for further yield spread compression. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
	Global high yield			We keep our strong overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency			We are underweight hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced.
	Emerging market – local currency			We are still underweight local-currency EM debt. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
	Asia fixed income			We upgrade Asia fixed income to overweight. China and other Asian countries have done better in containing the virus and are further ahead on economic recovery.

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