Weekly commentary

BlackRock

Nov. 30, 2020

Our latest credit views

- We have upgraded emerging market (EM) debt on a tactical basis as positive vaccine developments bolster the case for an accelerated global restart in 2021.
- Global stocks hit record highs as the transition of power officially started in the U.S. The rally fizzled on the virus resurgence and disappointing jobs data.
- This week's U.S. nonfarm payrolls data will be in focus after recent data pointing to softening activity. Markets are also waiting for a potential Brexit trade deal.

We have closed our tactical underweight in EM debt as easy monetary policy is expected to stay, against the background of an improved 2021 outlook. Positive news on Covid vaccine development has boosted the case for an accelerated global restart in 2021. This latest view change reflects our barbell approach between quality and cyclicality – with a tilt to cyclicality in our credit exposures.

Mike Pyle
Global Chief Investment Strategist – BlackRock Investment Institute

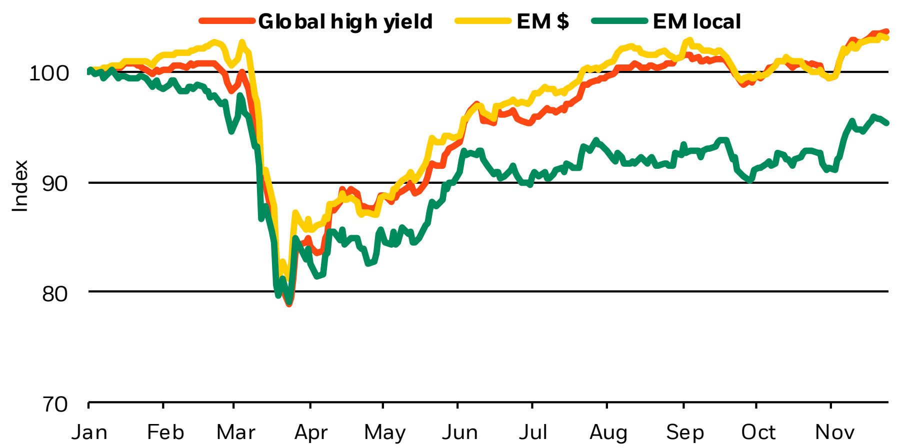
Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute

Beata Harasim
Senior Investment Strategist -BlackRock Investment Institute

Chart of the week

Total return of selected bond indexes, year-to-date 2020



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv, November 2020. Notes: The indexes used are the Bloomberg Barclays Global High Yield Index, JPMorgan EMBI Global Diversified Index and JPMorgan GBI-EM Composite Index. Performance is indexed to 100 on Jan. 1, 2020.

EM assets have underperformed their developed market (DM) peers for most of 2020, and have been playing catchup in recent weeks. A string of positive news reports on Covid vaccines boosted confidence in an accelerated restart during the course of 2021, setting up a positive overall backdrop for risk assets. Encouraging early results on the effectiveness of a Covid-19 vaccine that may offer lower costs and easier distribution bode particularly well for the EM world, in our view. Most EM assets have now delivered positive year-to-date returns after the recent rally. EM local-currency debt has lagged the market recovery in U.S. dollar terms, dragged down by heavy currency depreciation in many emerging markets. See the chart above. Yet we see potential for EM local-currency debt to catch up as EM currencies stabilize thanks to a stable or moderately weaker U.S. dollar. We also expect EM hard-currency debt to keep pace with high yield credit in developed markets, as higher yielding debt looks attractive to investors in search of income.

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BlackRock **Investment** Institute

The U.S. dollar is a key driver behind EM local-currency debt. We see risk appetite and interest rate differentials in turn driving the dollar's moves. More positive risk appetite as a result of the improved economic outlook should limit the demand for perceived safe-haven assets such as the dollar, in our view. At the same time, we see declining real rates as inflation firms and the Federal Reserve caps any gains in nominal bond yields. The likely result is a moderately weaker dollar. This should support EM currencies and local-currency debt. We also expect more predictable foreign affairs and trade policies under the Biden administration to provide an improved backdrop for the EM world. Our BlackRock geopolitical risk dashboard – tracking market attention to the top 10 geopolitical risks – shows attention to global trade tensions has dropped sharply from recent peaks after staying at elevated levels for much of the past three years.

China is an important part of EM growth dynamics. The world's second-largest economy is leading the global restart in activity, with its growth already at, or very close to, its pre-Covid trend. This bodes well for the rest of the EM world. Yet EM economies are also susceptible to the policy direction of China. Any aggressive tightening of monetary policy in China to prevent the economy from overheating – not our base case – could be negative for the rest of the EM complex, in our view. Another risk for some emerging markets: structural growth challenges and sharply rising debt levels in the wake of the Covid shock. Yet we do not see this as a near-term market risk due to ample global liquidity. Tactically we are overweight Asia fixed income as this region leads the global economic recovery. We view valuations in this market as attractive – and believe investors are well compensated for the risks. We are also overweight high yield – on both tactical and strategic horizons – as it provides attractive income in a yield-starved world.

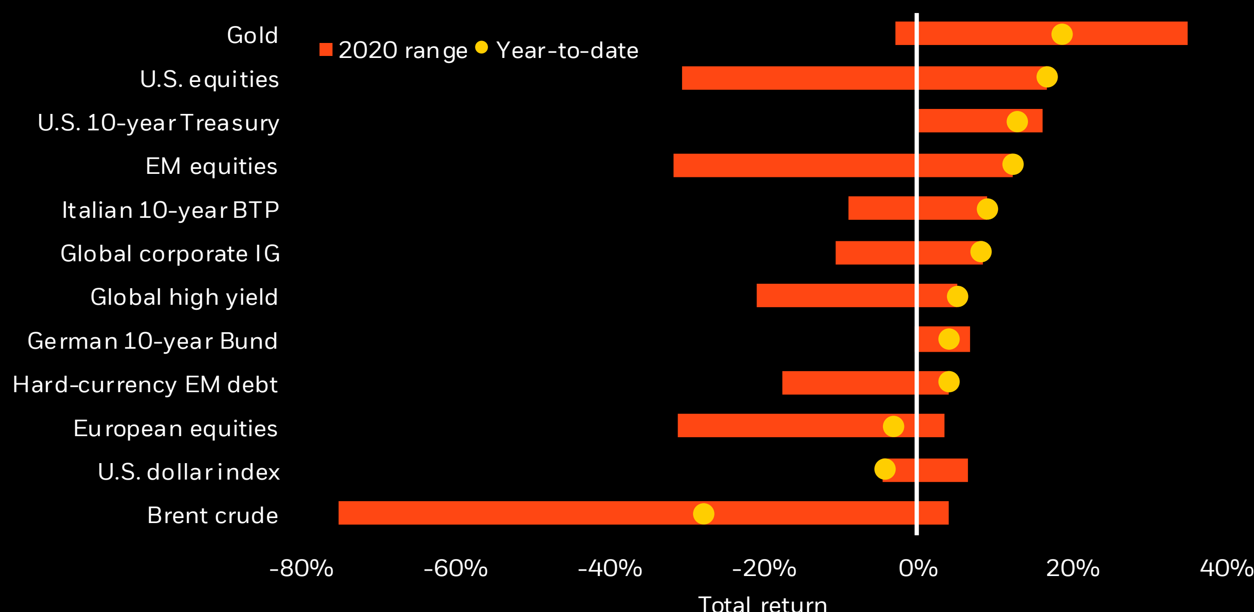
The bottom line: We expect global growth to rebound strongly in 2021 with the rollout of Covid vaccines. This is why we prefer to tilt more toward cyclicality in our credit views as we take a barbell approach to allocate risk exposure to both quality and cyclical assets. We have upgraded both local-currency and hard-currency EM debt to neutral, after having upgraded EM equities to overweight. Meanwhile we have downgraded global investment grade credit as its valuations have increased and we prefer more cyclical exposures such as high yield.

Market backdrop

Positive news on vaccine development and the formal start of U.S. President-elect Joe Biden's transition to the White House drove global stocks to record highs. The expected nomination of former Fed Chair Janet Yellen as the Treasury Secretary also helped lift the mood. Yet the rally fizzled after disappointing jobs data pointed to a slowing of the restart as the virus surges around the U.S. We still expect the cumulative economic hit from the Covid shock will be just a fraction of that seen in the wake of the global financial crisis.

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, November 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.

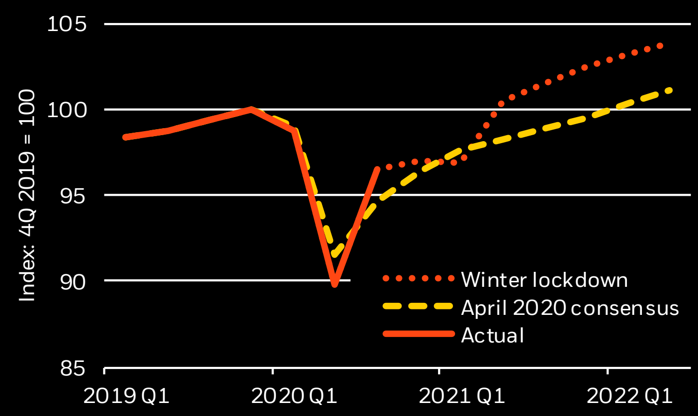
Macro insights

Positive news on Covid vaccines has boosted the outlook for the activity restart in 2021, yet near-term headwinds have grown. Rising infection rates and tighter restrictions in the U.S. are accompanied by growing risks of a premature end to key support measures. The economic restart could stutter in the near term – but activity should rebound by mid-2021 as effective vaccines become widely available, in our view.

Our estimate of tighter U.S. restriction measures points to a mild contraction in Q1 2021. A contraction would be especially likely if there is no additional fiscal stimulus agreed before year-end. There is a rising risk of permanent scarring if fiscal support is not extended. But we should see a more pronounced rebound in activity through the middle of 2021 as vaccines enable a broad restart. The political case for further fiscal support such as furlough programs is also boosted by vaccines – as policy makers now know they are building a bridge to somewhere.

Stop-go U.S. growth

U.S. GDP and GDP forecasts, 2019-2022



Sources: BlackRock Investment Institute, Refinitiv, with data from Haver Analytics, November 2020. Notes: The solid orange line shows the path of real GDP, indexed to 100 in the fourth quarter of 2019. The dotted orange line shows the implied level of GDP based on our estimate of restriction measures in coming quarters. The yellow dotted line shows the consensus expectation of real GDP as of April 2020, immediately after lockdown measures were first introduced.

Investment themes

1 Activity restart

- Positive Covid vaccine developments reinforce our expectation that the economic restart can gather steam again in 2021, even as the virus resurgence and renewed tighter restrictions look set to disrupt activity in the near term.
- We see renewed European lockdowns causing a contraction in the fourth-quarter GDP, and expect tighter U.S. restrictions to lead to a mild contraction in the first quarter of 2021.
- 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 strategic and tactical horizons. We are tactically overweight U.S., broad EM, Asia ex-Japan equities and the size style factor in the U.S., and underweight European equities. We have closed our underweight on EM debt.

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. Both fiscal and monetary policy support are still crucial before the vaccine rollout.
- Risks of policy fatigue are rising, especially in the U.S. as key policy provisions are due to expire at year-end. Risks are growing that no deal on a second fiscal package will be reached before President-elect Biden is inaugurated. A Biden administration could be constrained in implementing its key policy plans including large fiscal spending.
- The unexpected request by the U.S. Treasury that the Fed should wind up several emergency measures – against the Fed's desire to extend them further – indicates a difficult political backdrop to finding agreement on a fiscal extension. It also calls into question the central bank's independence in the long run.
- 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 it's 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 target levels. Combined with structural changes accelerated by Covid, it could lead to higher inflation in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on both strategic and tactical horizons.

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.

Week ahead

Dec. 1 Manufacturing purchasing managers' index (PMI) for Japan, China, the euro area, U.S. and UK

Dec. 4 U.S. nonfarm payrolls

Dec. 3 Services PMI for Japan, China, the euro area, U.S. and UK

This week's U.S. labor market report will be in focus, especially after recent weeks' disappointing jobless claims data. A string of recent data has shown signs of activity flattening out in the U.S., even before some states tightened restrictions. Brexit could be back in the spotlight as markets await a potential trade deal with the European Union this week.

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 the U.S. and EM, especially Asia ex-Japan.
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 have cut IG credit to underweight in favor of more cyclical exposures. We prefer high yield for its income potential and have upgraded EM hard- and local-currency debt to neutral.
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 upgrade U.S. equities to overweight. We see quality companies in sectors such as technology offering exposure to ongoing structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
Equities	Euro area	■ ←●		We downgrade European equities to underweight. Renewed restrictions look set to weigh on activity over coming months. We also view European equities as structurally challenged in a post-Covid world.
Equities	Japan	■		We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration.
Equities	Emerging markets		■	We are overweight broad EM equities as more stable foreign and trade policy under a Biden administration could benefit EM assets.
Equities	Asia ex-Japan		■	We are overweight Asia ex-Japan equities. 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.
Equities	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.
Equities	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.
Equities	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.
Equities	Quality		■	We are overweight quality. We see it as resilient against a range of outcomes in the pandemic and economy.
Equities	Size		■	We are overweight size. We expect small- and mid-cap U.S. companies to likely benefit from a cyclical upswing over the next 6-12 months with positive Covid vaccine development, even as the outlook for large fiscal stimulus dims.
Fixed Income	U.S. Treasuries	■		We are underweight U.S. Treasuries. An accelerated economic restart in 2021 could spur higher yields and a steeper yield curve.
Fixed Income	Treasury Inflation-Protected Securities		■	We are overweight TIPS. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy and increasing production costs.
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 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.
Fixed Income	Global investment grade	■ ←●		We downgrade investment grade credit to underweight. We see little room for further yield spread compression and favor more cyclical exposures such as high yield.
Fixed Income	Global high yield		■ ←●	We trim our overweight in global high yield. Spreads have narrowed significantly, but the asset class remains an attractive source of income in a yield-starved world.
Fixed Income	Emerging market – hard currency	●→		We have upgraded 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 have upgraded 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 the asset class.
Fixed Income	Asia fixed income		■	We are overweight Asia fixed income. China and other Asian countries have done better in containing the virus and are further ahead on economic recovery.

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