Weekly commentary

BlackRock

Jan. 25, 2021

The new nominal takes shape

- Markets are waking up to inflation. This echoes our *new nominal* theme, which points to real yields staying deeply negative – a positive for risk assets.
- U.S. stocks hit record highs as President Joe Biden took office. Italy averted further political chaos as the government won a confidence vote in parliament.
- Markets will monitor U.S. consumer spending data this week to gauge the size of the pent-up demand that would be key to the speed of activity restart.

We have long flagged the potential for higher inflation in the medium term, and markets have awoken to this prospect amid expectations for large U.S. fiscal stimulus. We don't see this derailing the risk asset rally in the near term. We expect a muted response of nominal yields to inflation – our *new nominal* theme. This keeps us pro-risk, even as the road ahead could be bumpy due to virus dynamics.

Jean Boivin
Head – BlackRock Investment Institute

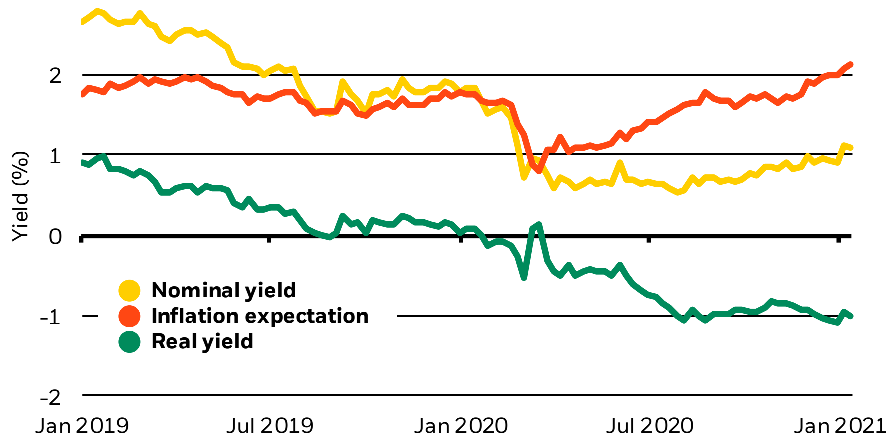
Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute

Beata Harasim
Senior Investment Strategist -BlackRock Investment Institute

Chart of the week

U.S. 10-year Treasury yield breakdown, 2019-2021



Sources: BlackRock Investment Institute with data from Refinitiv, January 2021. Notes: Nominal yield is represented by the Refinitiv U.S. Benchmark 10-year Government Bond Index. Real yield is represented by the yield of the Refinitiv U.S. 10-year TIPS Inflation-linked Government Bond Index. Inflation expectation is calculated by subtracting real yield from nominal yield.

The policy revolution that started in early 2020 to cushion the blow of the Covid shock is a major driver behind *the new nominal*, one of our three investment themes for 2021. A key consequence is the potential for a more muted response of nominal yields to higher inflation, in our view. Pricing of inflation expectations has risen to its highest level since October 2018 – helping drive nominal 10-year Treasury yields to the highest levels since last March. Yet "real" yields, or inflation-adjusted yields, have largely held steady. See the green line in the chart above. We had expected a united Democratic government to potentially accelerate the *new nominal*, as significant fiscal support could bolster the economic restart. Recent market moves are consistent with that view. We see room for nominal yields to rise as inflation grinds higher, yet expect the Federal Reserve to lean against any sharp rises. As a result, we could see range-bound nominal yields in the near term, and real yields remaining deeply negative.

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A key part of the policy revolution is the evolving policy framework of major central banks. The Federal Reserve has led the way by signaling a willingness to allow inflation overshoots to make up for past misses – while vowing to keep interest rates low for the foreseeable future. The Fed's policy meeting this week will likely echo this view, while noting the weakening of economic conditions since the last meeting in December. Already, recent moves in yields suggest markets will likely test the Fed's resolve to curb any excessive climb in nominal yields. This is part of the reason why we don't see the rise in nominal yields as a straight line. One potential side effect of the huge surge in debt levels caused by the policy revolution: over time, raising interest rates could become more politically fraught for central banks, and the risk of "taper tantrum" type events could complicate any attempts to normalize policy.

We see U.S. consumer price inflation in a range of 2.5%-3% over the next five years – still much higher than current market pricing. We see inflation triggered by two forces: higher production costs amid the remapping of global supply chains and new central bank frameworks that allow for inflation overshoots. Higher inflation and a limited rise in nominal yields should keep real yields negative, supporting risk assets. In this environment, the U.S. dollar could come under pressure as investors will likely seek higher-yielding assets outside of the U.S. We believe a stable or weaker dollar over the next 12 months supports emerging market assets.

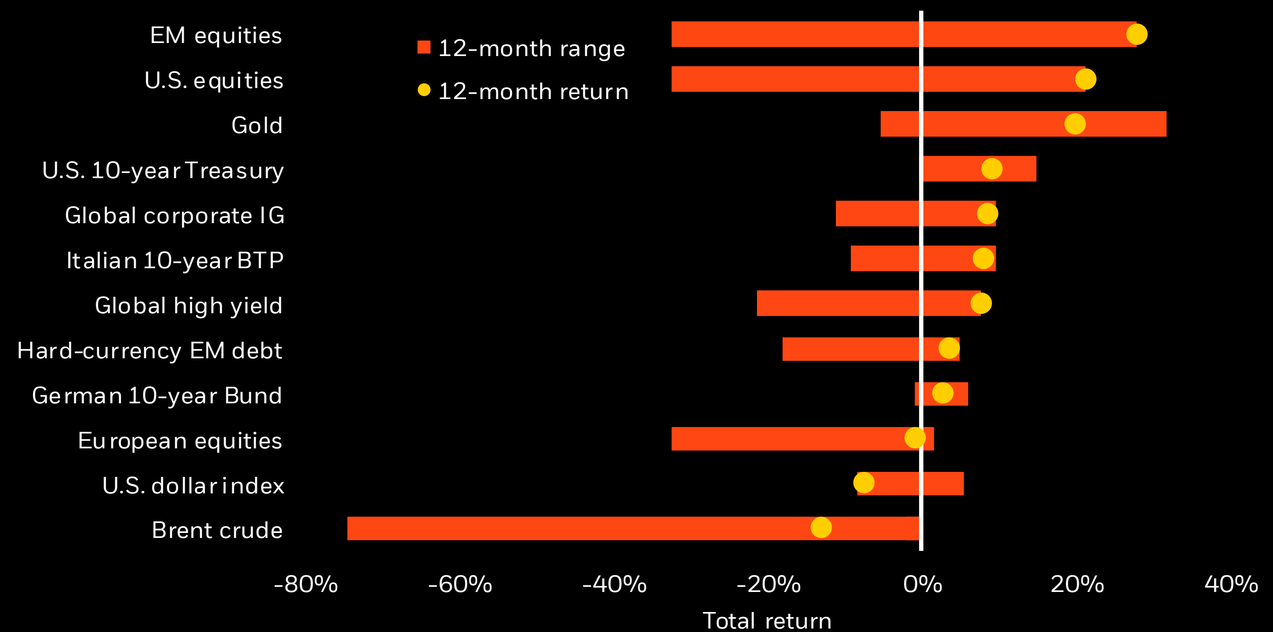
The bottom line: We still expect the cumulative impact on economic activity from the Covid shock – what ultimately matters for asset prices – to be just fraction of that seen after the global financial crisis. This is despite a delay in the restart caused by a slow start of the vaccine rollout and the spread of more transmissible virus strains. We see stronger growth, higher inflation and low real yields ahead, as the vaccine-led restart eventually accelerates and central banks limit the rise of nominal yields. On the tactical horizon we are pro-risk overall, favoring equities and credit. Yet it is likely to be a bumpy road ahead for risk assets, in our view, as markets have made significant moves since late last year. On a longer-term, strategic horizon, we are neutral on equities given increased valuations. We also have a strategic underweight in nominal government bonds as we see their role in portfolios challenged by low yields and rising inflation.

Market backdrop

U.S. stocks scaled new highs, as Democrat Joe Biden was sworn in as the 46th U.S. president in a peaceful transfer of power. Italy averted further political chaos as Prime Minister Giuseppe Conte survived a confidence vote in parliament. The early stages of the vaccine rollout have been slower than expected as more infectious strains of the virus are spreading, but we don't see this materially changing the cumulative economic impact of the virus shock.

Assets in review

Selected asset performance in the past 12 months



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, January 2021. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared with 12 months earlier. 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

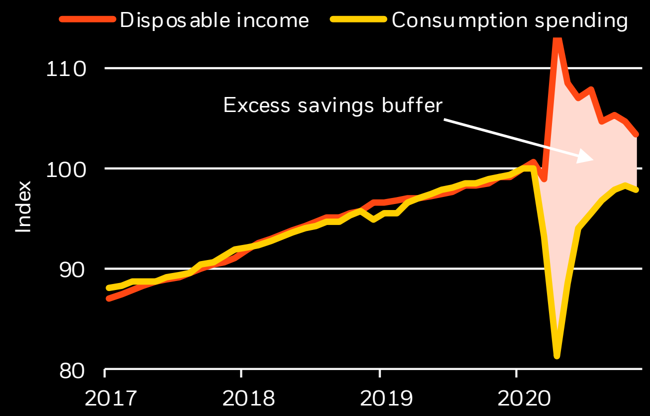
We see pent-up demand fuelling the U.S. economic restart. In particular, contact-intense services sectors are likely to rebound sharply once restrictions begin to ease, supported by a large accumulated amount of personal savings. See the chart on the right.

We estimate the accumulated stock of household savings in the U.S. to be about $1.5 trillion larger than the savings generated in the year before the pandemic – equal to about 7% of 2019 GDP. Much of this likely represents "forced" saving, with many households unable to spend the same proportion of their income as they have in the past. These "forced" savings should unwind as restrictions ease. The additional fiscal support announced last week should provide a further boost, in our view.

We view China as an example of how the pent-up demand could be released. Services output in China has almost returned to its pre-pandemic trend just three quarters after the virus has been brought under control.

Saving it up

U.S. incomes vs consumption, 2017-2020



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, with data from Haver, January 2021. Notes: The chart shows U.S. disposable incomes and personal consumption expenditures rebased to 100 as of January 2020. We assume difference between the two as the excess savings buffer households have built up as a consequence of limitations on how people typically spend their income. The latest data do not include the stimulus payments distributed at the start of the year, which should add further to the savings buffer.

Investment themes

1 The new nominal

- We see stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. Inflation will have different implications to the past.
- The policy revolution as a response to the Covid shock implies that nominal yields will be less responsive to rising inflation risk than in past episodes. This suggests risk assets will perform better than in past inflationary periods.
- The Democrats' slim majority in U.S. Congress improves the outlook for fiscal spending, likely fast tracking our expectations for stronger growth and lower real yields.
- Medium-term inflation risks look underappreciated. Production costs are set to rise on a rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past inflation undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- **Market implication**: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by falling real rates. Tactically we are pro-risk, preferring U.S. equities and high yield credit.

2 Globalization rewired

- The pandemic has accelerated geopolitical transformations such as a bipolar U.S.-China world order, and a rewiring of global supply chains for greater resilience. We believe investors need exposure to both poles of global growth.
- Strategic U.S.-China rivalry looks here to stay, particularly in tech. The Biden administration is likely to shift away from a focus on bilateral trade deficits to a multi-lateral approach in trade. The administration will likely seek to balance cooperation on climate change and public health within a broader U.S.-China agenda that includes areas of potential heightened tensions such as trade and human rights.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a clear case for greater exposure to China-exposed assets for returns and diversification, in our view.
- We expect persistent inflows to Asian assets as many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels, yuan depreciation and U.S.-China conflicts. But we believe investors are well compensated for these.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like EM equities, especially Asia ex-Japan, and are underweight Europe and Japan.

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 outperformance 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 prefer sustainable assets amid a growing societal preference for sustainability. Tactically we take a barbell approach, favoring quality stocks balanced with selected cyclical exposures.

Week ahead

Jan. 25 Germany IFO Business Climate Survey

Jan. 26 U.S. consumer confidence

Jan. 27 Federal Open Market Committee policy meeting concludes

Jan. 29 U.S. personal consumption expenditures

This week's U.S. consumer spending data will be a focus. The personal consumption expenditures (PCE) data, as part of the personal income and outlays release, could help markets gauge the pent-up demand that has accumulated in the U.S. as consumers have amassed a large savings buffer since last February. We expect the activity restart to accelerate later this year – and the pent-up demand will be key to determine the magnitude of the rebound.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	Neutral	+1	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We tilt toward EM equities. Tactically, we have upgraded equities to overweight as we expect the restart to re-accelerate and rates to stay low. We like a barbell approach: quality stocks balanced with selected 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 see the economic restart and ongoing policy support helping credit perform, even amid tighter yield spreads and the wind-down of some emergency credit support.
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 policy accommodation suppresses yields.
Cash		Neutral	We are neutral and use cash to fund overweights in equities and credit. Holding some cash makes sense, in our view, as a buffer against the risk of 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. 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.

Note: Views are from a U.S. dollar perspective, December 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, January 2021

	Asset	Underweight	Overweight	
Equities	United States			We have upgraded U.S. equities to overweight. 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 have downgraded European equities to underweight. The market has relatively high exposure to financials pressured by low rates. It also faces structural growth challenges, even given potential for catch-up growth in a vaccine-led revival.
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. 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 been more effective at containing 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	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 its 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 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 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 is likely to be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields as staying rangebound, but real yields declining amid rising inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
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 structurally accommodative monetary policy, significant fiscal spending, 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 have downgraded investment grade credit to underweight. 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 have trimmed our overweight in 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 have upgraded hard-currency EM debt to neutral. 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 to neutral. 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 EM.
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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