Weekly commentary

BlackRock

Feb. 22, 2021

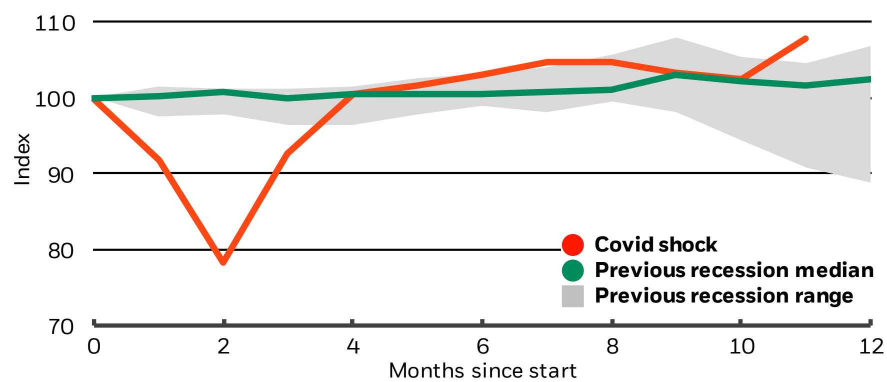
Downgrading government bonds

- Recent developments lead us to refresh our asset views, including a broadening of our cyclical tilt and a tactical downgrade to government debt and credit.
- Rising inflation expectations have driven up U.S. 10-year Treasury yields but to a lesser degree than in the past. Real yields were steady in negative territory.
- U.S. consumer confidence data this week could bolster the expectation for a vaccine-led restart after retail sales rebounded strongly in January.

We broaden our tactical pro-risk stance in light of major developments since the publication of our 2021 outlook in December: the vaccine rollout and up to $2.8 trillion of additional U.S. fiscal spending this year. Inflation expectations have risen sharply while real rates are steady in negative territory. We prefer equity over credit and turn underweight government bonds – in line with our strategic views.

Chart of the week

U.S. retail sales during past recessions and the Covid shock



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2021. Notes: The chart compares the path of total U.S. retail sales during business cycle contractions with that during the Covid shock. Retail sales are rebased to 100 at the peak of each business cycle as defined by the National Bureau of Economic Research (NBER). The grey area shows the range based on cycles starting with 1969. The Covid shock line is rebased to 100 at February 2020.

Our *new nominal* theme – which flags a more muted response in nominal bond yields to rising inflation than in the past – has played out since last year. A 1% increase in 10-year U.S. breakeven inflation rates – a measure of market inflation expectations – has typically led to 0.9% rise in 10-year Treasury yields since 1998, we estimate. Yet since last March breakeven inflation has climbed 1.2%, and nominal yields are up just 0.5%. Inflation-adjusted yields, or real yields, have fallen further into negative territory as a result. The different nature of the Covid shock means activity has restarted much faster than seen in past business cycle recessions – and implies unusually high growth rates as a vaccine-led re-opening unfolds. The surprising jump in January U.S. retails sales may offer a glimpse of things to come. See the chart above. Fresh U.S. fiscal spending is turbocharging the restart, with recent pandemic relief payments explaining some of the retail sales boost. Further spending will ensure another wave of support, in our view.

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We expect a strengthening economy, a huge fiscal impulse and rising inflation to further drive up nominal yields this year, albeit by less than in similar periods in the past. We expect central banks to lean against any market concerns around rising debt levels and to keep interest rates low for now. Yet if the narrative on high debt levels, combined with rising inflation, were to change, it could eventually undermine the markets' faith in the low-rate regime – with implications across asset classes.

We have downgraded government bonds to underweight on a tactical basis, with an increased underweight in U.S. Treasuries. We also downgrade euro area peripheral bonds to neutral, as peripheral yields have fallen to near record lows and spreads have narrowed. We downgrade credit to neutral on a tactical horizon, as spreads have narrowed to historical lows, but still like high yield for its income potential.

Tactically, we now prefer equities over credit, as equity valuations appear more attractive. We also broaden our cyclical tilt: We are upgrading European equities to neutral, as we see room for the market to close its valuation gap versus the rest of the world with the restart becoming more entrenched. Yet the slow vaccine rollout and more muted fiscal support weigh. We debut an overweight call on UK equities in the wake of Brexit. We stay overweight U.S. and emerging market (EM) equities, and underweight Japan, where we expect lower risk-adjusted returns.

Over a strategic horizon, we also prefer equities over credit. We turn underweight credit due to rich valuations and are now modestly overweight equities. This preference stems from incorporating the effects of climate change in our long-term expected returns. We see developed market equities best positioned to capture the opportunities from the climate transition – particularly on a sector level where we see material effects on expected returns. Equities valuations are also closer to long-term averages after factoring in historically low interest rates and an improving earnings outlook.

The bottom line: We expect our *new nominal* theme of stronger growth and a muted response in nominal bond yields to higher inflation to further play out, even after significant market moves. This supports our tactically pro-risk stance. A key risk is a further increase in long-term yields as markets grapple with an economic restart that could beat expectations. This could spark bouts of volatility, even though we believe the Fed would lean against any sharp moves for the time being.

Market backdrop

U.S. 10-year Treasury yields hit the highest levels in nearly a year. Nominal yields have been climbing since September, but the magnitude has lagged that of the rise in inflation expectations during the period. Inflation-adjusted yields have been stable in negative territory – in line with our *new nominal* theme. U.S. stocks hit new high on fiscal stimulus hopes. Crude oil prices rose to the highest levels in over a year as a rare cold snap hit oil production in Texas, the biggest oil-producing state in the U.S.

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 It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, February 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: 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.

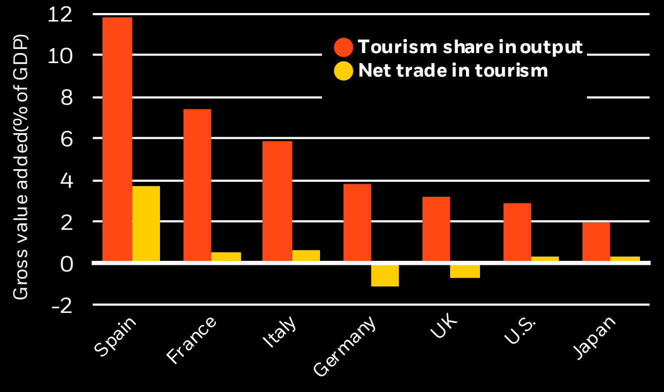
Macro insights

New Covid-19 strains have stirred unease for their potential to spread more easily or lower the efficacy of vaccines. Yet recent developments around the new variants are unlikely to challenge the 2021 economic restart, in our view. First, most existing vaccines appear to be effective against the variants, especially in preventing hospitalizations – key to the economic restart. Second, any near-term disruptions will likely be followed by a faster activity restart later.

But over the longer term these Covid-19 variants do suggest some targeted restrictions on activity will likely remain in place. One example: international travel controls. Vaccine certificates, being considered in the UK and Denmark, may allow travel to happen. We expect economies reliant on tourism to take longer to see holidaymakers return to pre-Covid levels. Countries such as Spain, France and Italy have positive net tourism earnings : they earn more from foreign tourists than they lose from domestic tourists abroad. See the yellow bars. These countries may find it harder to make up for lost revenue from foreign tourists with domestic ones.

Travel controls

Contribution of tourism to economy, February 2021



Sources: BlackRock Investment Institute, with data from the OECD, February 2021. Notes: The orange bars show the contribution of tourism to overall economic output. The yellow bars show whether countries are net exporters or importers of tourism. The bars represent revenue from foreign tourists minus spending by individuals abroad. A positive number means a country receives more in tourism revenue from overseas visitors than its own citizens spend on tourism abroad.

Investment themes

1 The new nominal

- We see a more muted response of government bond yields to stronger growth and higher inflation than in the past, as central banks lean against any sharp yield rises. This should support risk assets, even as the restart takes shape.
- Medium-term inflation risks look underappreciated. Production costs are set to rise amid the rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- The policy revolution has led to a surge in public debt – and increased tolerance for it. We don't see high debt levels as a concern in the near term. Yet there are risks bubbling below the surface – over time we could see a change in the premium for the perceived safety of government debt, with major market implications.
- **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.
- 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. It will also 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 developments have been incrementally positive over the past 12 months, and investors are well compensated for these risks.
- **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 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 see returns being driven by climate change impacts, and view developed market equities as the asset class best positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

Feb. 22 Germany's ifo Business Climate Index

Feb. 23 U.S. consumer confidence

Sentiment data in the U.S. and Europe could shed light on the status of the activity restart. U.S. consumer confidence data could further bolster the expectation for a forceful restart, after January's retail sales data rebounded sharply after households received additional pandemic relief payment.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We turn 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, we downgrade credit to neutral following the tightening in spreads, particularly investment grade. 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 turn 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		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, February 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, February 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 turn neutral European equities. We believe that there is room for the market to close the valuation gap vs. the rest of the world as the economic restart becomes more entrenched.
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 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 underperformance. 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 has historically lagged 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 may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries	■ ←● ■		We are underweight U.S. Treasuries. We see nominal U.S. yields rising but largely due to a repricing higher of 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 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 closing our overweight to euro peripheral bond markets that we have held since April 2020. 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 neutral 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 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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