Weekly commentary

April 26, 2021

Why we remain pro-risk

- We stick to our pro-risk stance and tweak our tactical views as the U.S. leads a powerful global economic restart and our *new nominal* theme plays out.
- Stocks were little changed on the week as markets digested strong first quarter earnings reports and bond yields eased.
- The Federal Reserve policy meeting will be in focus as markets look ahead to a potential tapering of its bond purchases to be signaled as early as June.

A powerful economic restart is underway in the U.S. – with Europe and emerging markets (EMs) set to follow. At the same time our *new nominal* theme has been playing out, with a hefty jump in inflation expectations but a more muted rise in nominal yields. Against this backdrop, we reiterate our pro-risk stance and refine our tactical views in response to adjustments in market pricing and valuations.

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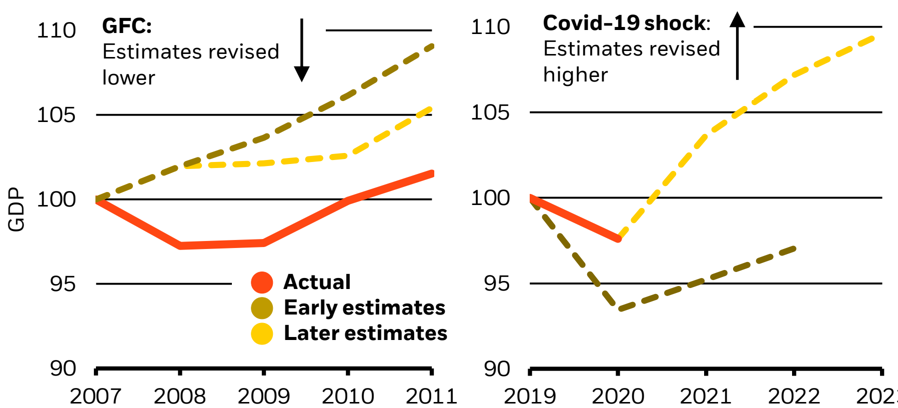
Chart of the week

U.S. GDP estimates, global financial crisis and Covid-19 shock



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, Federal Reserve, and Reuters News, with data from Haver Analytics, April 2021. The charts show the level and estimates of U.S. GDP over time for the global financial crisis (GFC) and the Covid-19 shock. Both series are rebased to 100 for the year prior to the shock – 2007 and 2019. Estimates are from the Fed's Federal Open Markets Committee's Summary of Economic Projections published through 2008 on the left and 2020-21 on the right. The level of GDP is derived from the FOMC's forecasts of GDP growth from the fourth quarter of the prior year to the fourth quarter of the current year. Early estimates are as of Jan 2008 for GFC (June 2020 for Covid); later estimates as of Nov. 2008 (Mar. 2021 for Covid).

We are at an uncertain juncture in markets. Investors are grappling with how to interpret unusual growth dynamics and new central bank frameworks. On the first, U.S. activity looks set to restart strongly this year, powered by pent-up demand across income cohorts and sky-high excess savings. Growth forecasts have been catching up, as the chart above shows, but the magnitude of the restart may still be underappreciated. This is in stark contrast to the repeat growth disappointments seen after the global financial crisis – and reflects the different nature of this shock. We see it as more akin to a natural disaster followed by a rapid "restart" – rather than a traditional business cycle recession followed by a "recovery." This is why a year ago we warned against extrapolating too much from the steep decline in activity. Now the same is true – but in reverse. U.S. growth will likely peak over the summer but the eye-popping data will be transient: the more activity is restarted now, the less there will be to restart later. We see the rest of the world following the U.S. and reopening as vaccine rollouts pick up pace.

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The second dynamic investors are grappling with is new central bank frameworks. Our *new nominal* theme helps us navigate this environment. The Federal Reserve is building credibility in its new framework and has set a high bar to change its easy policy stance, even in face of higher realized inflation. This has yet to be fully digested by markets, in our view. We see markets still underestimating the potential for the Fed to achieve above-target inflation in the medium term as it looks to make up for persistent undershoots in the past. This is why we think the direction of travel for yields is higher. But we believe the overall adjustment will be much more muted than one would have expected in the past based on growth dynamics – and much adjustment has already taken place.

As a result of these two key dynamics, we maintain our pro-risk tactical view. We remain overweight equities, neutral credit and underweight government bonds on a tactical basis. Yet we have tweaked some of our tactical views given significant moves in market pricing. For example, 10-year Treasury yields have more than tripled from last year's lows around 0.5%. This leaves less room for further rises in yields on a tactical horizon, in our view. U.S. inflation expectations also have come a long way since we moved to an overweight in U.S. Treasury Protected Securities (TIPS) early last year. As a result, we are trimming our tactical underweight to U.S. Treasuries and closing our overweight in TIPS – even as we see room for yields to push higher and inflationary pressures to build further in the medium term. In a world starved for income, we have upgraded EM local currency debt on attractive valuations and the prospect of a stable dollar as the restart broadens, prefer high yield over investment grade credit and see opportunities in private markets. Within equities we express our pro-cyclical stance through overweights to EM and U.S. small caps as beneficiaries of the vaccine-led restart.

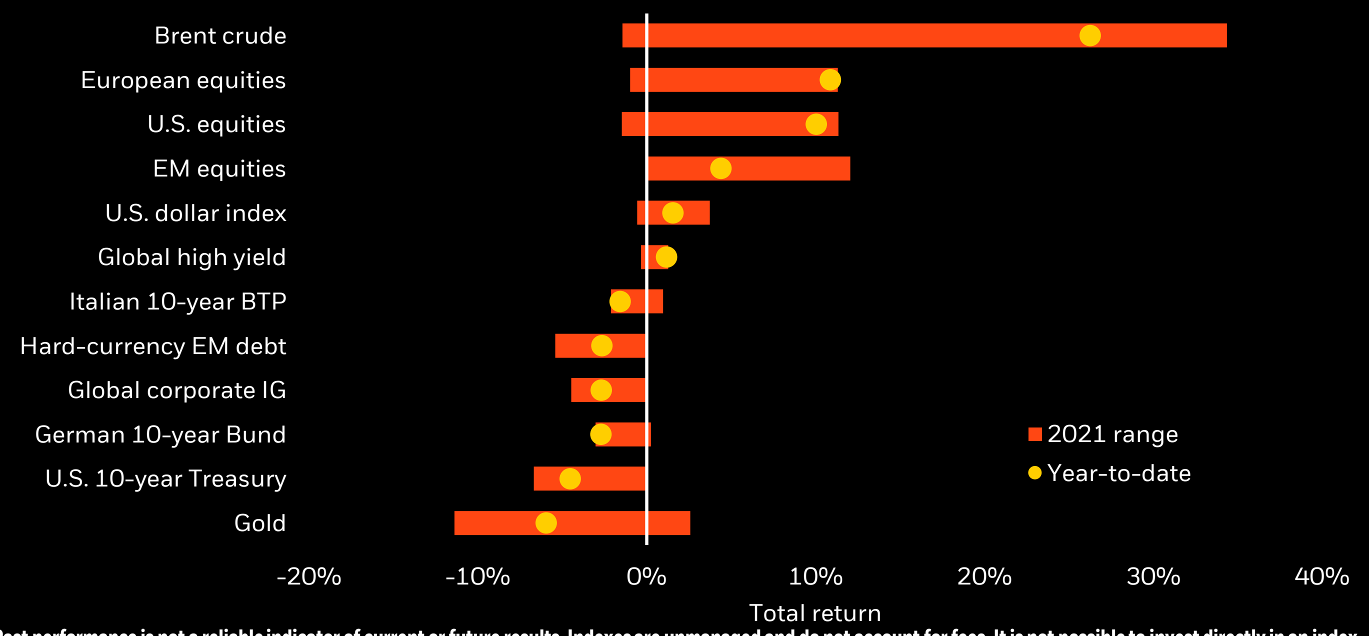
Bottom line: The broadening restart – coupled with our belief that this will not translate into significantly higher rates – underpins our pro-risk stance. Risks remain, however, on the tactical horizon. One is a market overreaction to exceptional growth data in the months ahead. We may see bouts of volatility as markets test the Fed's resolve to stay "behind the curve" on inflation. Any temporary spikes in rates may challenge EM assets in particular, but we advocate staying invested and looking through any turbulence as our "new nominal" plays out. Want to know more? BII's Global Outlook (GO) meeting on April 27 is a chance to hear from us directly and ask questions. Contact your BlackRock relationship manager for details.

Market backdrop

A decline in U.S. Treasury yields and strong corporate earnings are providing some support to equities. Some 87% of S&P 500 companies have beaten estimates for the first quarter, with just under one-fifth having reported, Refinitiv data showed as of Thursday. The five largest S&P 500 companies report this week. The Bank of Canada last week said it would start to taper down its asset purchases, becoming the first major central bank to signal an exit from quantitative easing. This comes ahead of a Federal Reserve policy meeting where the central bank is likely to reiterate its desire to stay "behind the curve."

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 April 22, 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, MSCI Emerging Markets Index, the ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, Refinitiv Datastream Italy 10-year benchmark government bond index,, Refinitiv Datastream Germany 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, J.P. Morgan EMBI index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

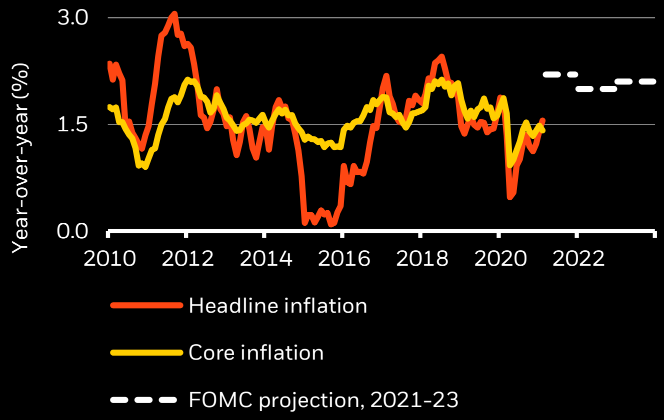
We see the drivers of the current U.S. inflation spurt as different from those that should produce a higher inflation over the medium term. Yet the inflation overshoot against a backdrop of accelerating growth as the economy reopens provides a test of the Federal Reserve's new policy framework.

The chart shows headline and core inflation against the Federal Open Market Committee's projections. We see three factors responsible for a near-term spurt in inflation: base effects that will distort year-on-year comparisons, global and local supply constraints and considerable pent-up consumer demand and excess savings.

All three effects are likely to be transitory, in our view, yet the surge in inflation has medium-term implications. Our view of higher medium-term inflation rests in part on the Fed sticking to its average inflation targeting policy framework, and looking to normalize monetary policy much more patiently than in the past. If inflation expectations were to become unanchored, inflation could start to rise in a more sustained manner.

A long way from targets

U.S. inflation and Fed projections



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, Federal Reserve, with data from Haver Analytics. Note: the dotted lines show the Fed's projection for quarter-on-quarter core personal consumption expenditure for the fourth quarter in 2021, 2022 and 2023. The data comes from the Fed's March 2021 Summary of Economic projections.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart, powered by pent-up demand and sky-high excess savings. The huge growth spurt will be transitory, in our view. This is because a restart is not a recovery: the more activity restarts now, the less there will be to restart later.
- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – was confirmed by the Fed's March policy meeting. The Fed made it clear that the bar for reassessing its policy rate path was not met and that it was too soon to talk about tapering bond purchases. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **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.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels and U.S.-China conflicts, but we believe investors are 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 strong performance 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 an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

April 27	Bank of Japan policy decision	**April 29**	U.S. GDP (advance)
April 28	U.S. FOMC policy decision; President Biden address to joint session of Congress	**April 30**	Japan and China manufacturing PMIs; euro area preliminary GDP

The FOMC policy meeting will be in focus this week. Our *new nominal* theme that nominal yields will be less sensitive to expectations for higher inflation was confirmed by the Fed in the last policy meeting, a clear reaffirmation of its commitment to be well "behind the curve" on inflation. Elsewhere, U.S. President Joe Biden is expected to make the case in an address to Congress for a more than $2 trillion infrastructure package as well as accompanying tax reforms that would partly fund it.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are 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, credit, especially investment grade, has come under pressure from tightening spreads, but 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 are 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		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 not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, April 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, April 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 are neutral European equities. We believe the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
Equities	Japan	■		We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a 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 turn neutral min vol. Our regional and sectoral preferences warrant a higher exposure to the factor. Min vol's underperformance has brought valuations to more reasonable levels in our view.
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 trim our underweight to U.S. Treasuries by one notch following the sharp move up in yields in response to the accelerated economic restart. We prefer to stay underweight as we expect short-term rates will stay anchored near zero.
Fixed Income	Treasury Inflation-Protected Securities		■	We turn neutral TIPS following the sharp rise in inflation expectations since late year. Further increases seem unlikely in the near-term. We still see inflation pressures building over the medium term due to structural reasons.
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 neutral euro peripheral bond markets. 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 upgrade EM local debt to overweight as its year-to-date underperformance has left valuations more appealing, particularly if U.S. Treasury yields and the U.S. dollar stabilize. We see limited contagion to broader EM from selected country-specific volatility.
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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