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Weekly commentary

May 24, 2021

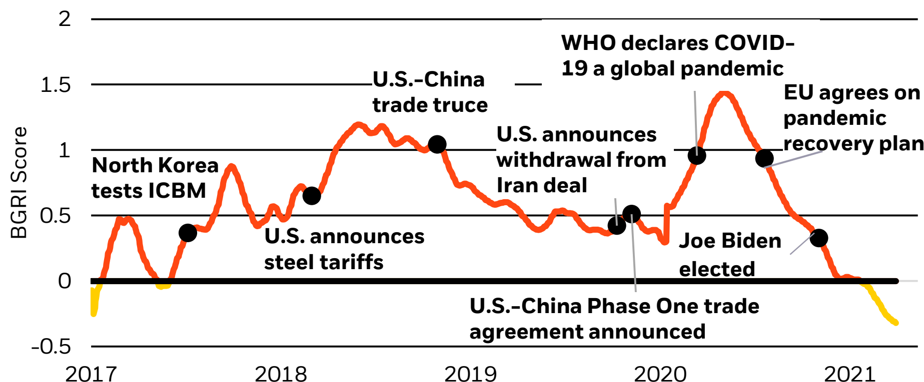
Gauging geopolitical risks

- The market focus is on the restart and inflation - and less on geopolitical risks – yet it's worth watching specific risks as flareups could catch investors off guard.
- Inflation expectations eased on lower oil and commodity prices. We expect volatile near-term data amid pent-up consumer demand and supply shortages.
- Data are expected to show the U.S. personal consumption expenditure (PCE) price index rose 2.8% in April, above the Federal Reserve's inflation target.

Market attention to geopolitical risks has fallen to four-year lows, our refreshed Geopolitical risk dashboard shows. We believe this is justified, as investors appear more focused on the economic restart and inflation outlook and less concerned about geopolitics since the change in U.S. administration. Yet it's worth watching specific risks as flareups can catch investors off guard when attention is low.

Chart of the week

BlackRock Geopolitical Risk Indicator - global



Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, May 2021. Notes: The BlackRock Geopolitical Risk Indicator (BGRI) tracks the relative frequency of brokerage reports (via Refinitiv) and financial news stories (Dow Jones News) associated with specific geopolitical risks. We adjust for whether the sentiment in the text of articles is positive or negative, and then assign a score. This score reflects the level of market attention to each risk versus a 5-year history. We use a shorter historical window for our COVID risk due to its limited age. We assign a heavier weight to brokerage reports than other media sources since we want to measure the market's attention to any particular risk, not the public's.

Our dashboard gauges market attention to overall geopolitics and to each of our top-10 risks by tracking the relative frequency of brokerage reports and financial news stories associated with the risks through BlackRock Geopolitical Risk Indicators (BGRIs). The global BGRI score has been trending down in the past year because of fading attention to risks such as *U.S.-China strategic competition*, *Covid-19 resurgence* and *Gulf tensions*. It has hovered in negative territory this year, as the chart shows, meaning market attention to geopolitical risks is below the average of recent years. Overall, this indicates a significant reduction in concern about geopolitical risk since the change in U.S. administration. Our dashboard also provides BlackRock's fundamental assessment of the likelihood of each risk materializing in the near term. We also introduce a new quantitative measure that seeks to gauge how similar the current market environment is to our estimate of market movement in the event the risk materialized.

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BlackRock **Investment** Institute

We introduce four new risks in the dashboard: *Covid-19 resurgence*, *Emerging market political crisis*, *Global technology decoupling* and *Climate policy gridlock*. Market attention to *Covid-19 resurgence* appears low, but we assign medium likelihood to this risk; attention to *Emerging market political crisis* is relatively elevated, yet we see a low likelihood. We see a high likelihood that decoupling of the U.S. and Chinese tech sectors accelerates in scale and scope, despite the relatively low attention to the *Global technology decoupling* risk. The pace of global reshoring of technological supply chains has sped up, potentially increasing production costs. This supports our view that markets are underpricing medium-term inflation risks. The Biden administration is continuing its predecessor's posture of intense rivalry with China, with a focus on critical technologies, and China has made tech self-reliance a top priority. We believe it's key to invest in both these poles of global growth, as detailed in The role of Chinese assets. U.S.-China tensions over Taiwan have been rising. We do not see near-term risks of military showdown but believe there is a significant medium- and long-term threat.

Climate policy gridlock refers to the risk that developed economies fail to increase public investment and regulatory action to achieve their goals to reduce carbon emissions. Attention to this risk appears low, as reflected in our BGRI, in line with our assessment of a low likelihood. We believe avoiding climate-related damages will help drive growth and improve risk asset returns, and have included the effects of climate change – and a climate transition – in our long-term return assumptions.

In some cases our dashboard reveals a disconnect between market attention and our fundamental analysis. Two examples: First, attention to *Major cyberattack(s)* risk has receded from a 2020 peak yet we see a high likelihood of this risk occurring. The recent hacking of a U.S. oil pipeline – and its impact on energy markets – highlights the risk. Second, market attention to a potential *North Korea conflict* is well below the historical average, but we rate the likelihood of the risk as "medium" – and see tensions as likely to increase heading into 2022. North Korean provocations, including long-range missile tests and potential for a nuclear test, could trigger a possible escalation.

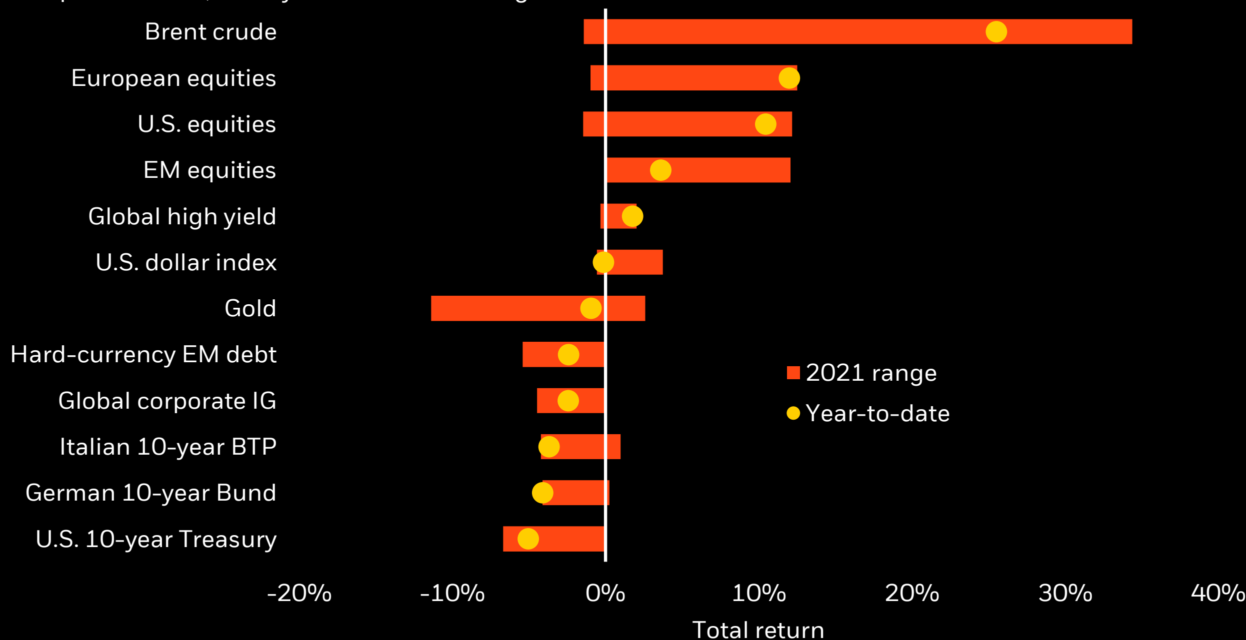
The bottom line: We see a relative decrease in market attention to geopolitical risks as justified, particularly in light of powerful key near-term market drivers such as the economic restart and inflation outlook. We remain pro-risk, but note that geopolitical risk flareups could have an outsize impact when markets least expect it.

Market backdrop

Market inflation expectations eased last week, driven partly by a sharp drop in crude oil and broad commodity prices – after the U.S. consumer price index (CPI) surged by more than expected in April. Economic data have been erratic, and we expect more of the same as economies restart amid pent-up consumer demand and supply shortages. We advocate looking through near-term market volatility and remain pro-risk, predicated on our belief that the Federal Reserve faces a very high bar to divert from its new policy framework to keep yields low.

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 May 20, 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 Europe Index, MSCI USA Index, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), spot gold, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

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Macro insights

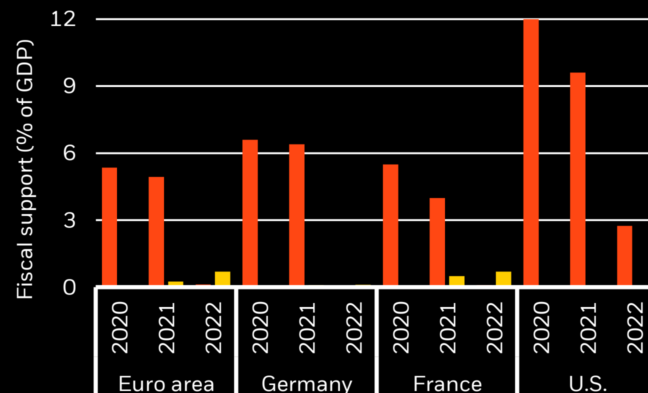
The European restart looks set to resume as mobility restrictions are gradually lifted. The bloc's vaccination rollout is gathering pace after a sluggish start. This expectation of a delayed restart ultimately taking shape was one reason we upgraded European equities to neutral earlier this year.

Policy support – from key fiscal measures taken at the European Union (EU) and national level to the European Central Bank maintaining easy financing conditions – will be crucial to the restart's staying power. Withdrawing policy support too early would raise the risk of permanent economic scarring, in our view. The suspension of EU debt and deficit rules until at least 2023 and the prospective disbursement of funds from the EU's Recovery and Resilience Fund (RRF) are encouraging signs. Covid-related fiscal support in 2021 has been on par with last year's, as shown in the chart.

We believe Europe will avoid a fiscal cliff once the restart completes. The focus can then shift to long-term priorities on green investment, digital transformation and raising potential growth. See our macro insights hub for more.

Fiscal support

Euro area vs U.S. Covid-related fiscal spending, 2020-2022



Source: BlackRock Investment Institute, May 2021. Notes: The chart shows average broker estimates of the discretionary spending measures introduced in response to Covid-19. For euro area economies, total spending is broken down into estimates of the contribution from borrowing by national governments (orange) and the contribution funded by the EU Recovery and Resilience Facility, assuming funds begin to get disbursed towards the end of 2021.

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 recent policy meetings. 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. Pending legislation in the U.S. would direct large-scale investment to meet the China challenge. 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. We see a risk of social unrest.
- **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.

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Week ahead

May 25	Germany ifo business climate survey; U.S. consumer confidence
May 27	Japan consumer price index, jobs report
May 28	U.S. personal income and outlays, including PCE inflation

U.S. consumer data and PCE inflation will be in focus this week. PCE inflation, the Fed's preferred inflation gauge, is expected to increase 2.8% in April – above the Fed's 2% inflation target. Personal consumption expenditures will provide clues on household spending and saving decisions after the last round of stimulus checks.

Directional views

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

Asset	Strategic view	Tactical view	Change in view (Previous → New)
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, May 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.

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Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 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 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 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 are underweight U.S. Treasuries. The accelerated economic restart has sent yields surging, but we prefer to stay underweight as we expect short-term rates will stay anchored near zero.
Fixed Income	Treasury Inflation-Protected Securities			We are neutral TIPS after 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 are overweight EM local debt 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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