Weekly commentary

BlackRock

June 14, 2021

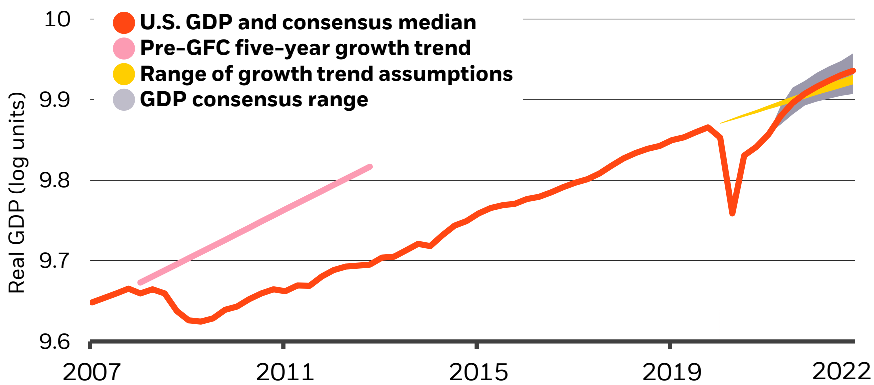
What lies beyond the restart?

- BlackRock's senior executives and portfolio managers discussed what lies beyond the restart – and investment implications - at our semi-annual forum.
- U.S. consumer price index (CPI) jumped in May and key drivers appear related to activity restart. Stocks rallied to record highs and bond yields fell.
- The Federal Reserve's policy meeting will be in focus this week. We expect the Fed to stress the transitory nature of the inflation surge.

BlackRock's senior executives and portfolio managers gathered virtually at our midyear outlook forum at a critical juncture in markets – with a pro-risk consensus over the tactical horizon. Beyond the near-term restart, they expressed a wide range of views on topics including growth and inflation, and identified a few key long-term investment themes including the climate transition, China and policy.

Chart of the week

U.S. GDP growth trend after the global financial crisis and Covid shock



Sources: BlackRock Investment Institute, Reuters with data from Haver Analytics, June 2021. Notes: The pink line represents the extrapolation of the five-year growth trend preceding the global financial crisis (GFC). The yellow area represents a range of assumptions for trend growth following the Covid shock. The orange line represents actual U.S. GDP up to the first quarter of 2021 and the median forecast from the second quarter of 2021 to the last quarter of 2022, based on the latest Reuters poll as of May 13, 2021. We plot the log of GDP so that the slope of the line indicates the trend growth rate.

The global economy and markets are at the most consequential moment since our outlook forums started a decade ago. The bounce back from the Covid shock has been remarkably swift, reflecting our view that this is a restart, not a usual business cycle recovery. This is in stark contrast to the global financial crisis (GFC) and the "lost decade" that followed. Median forecasts now point to a period of above-trend growth of the U.S. economy, according to the latest Reuters poll. See the chart above. This is unusual, as typically growth takes time to pick up to trend again after a downturn. The bigger question: What lies beyond? Views among forum participants differed on whether the restart is the start of a broader pickup in animal spirits, the acceleration of trends that boost potential growth, or a return to something more like a typical mid- or late-cycle. Many saw U.S. inflation exceeding the Fed's target in the medium term – a big turnaround from the tepid inflation expectations of a year earlier. The BlackRock Investment Institute (BII) sees U.S. CPI inflation averaging just under 3% between 2025-2030, and believes this is still underpriced by markets.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on global economy, markets and geopolitics.

BlackRock **Investment** Institute

Strong consensus emerged among forum participants on some long-term investment themes. These include the transition to a net-zero economy, an enduring policy revolution, opportunities in Chinese assets despite structural U.S.-China tensions, and the key role of technological innovation. Tech will be critical for solving structural problems such as ageing societies and the resulting decline of labor participation; it is also key to our sectoral views on incorporating the effect of climate change – and that of the "green" transition – in our long-term return assumptions. The net-zero transition requires huge investments, changes in business models and innovation. There is no roadmap for such a tectonic shift – one that we believe markets are underappreciating. The transition could create sustained demand for commodities such as copper and lithium that are critical for electrification, but may also exacerbate a near-term supply/demand imbalance in oil, spurring price volatility.

China is key to the net-zero transition. China, the world's largest greenhouse gas emitter, has pledged to achieve carbon neutrality before 2060 and peak carbon emission by 2030. More broadly, we view China-related assets as core strategic holdings as we believe investors need exposures to China in an increasingly bi-polar U.S.-China world order.

We see our *new nominal* investment theme – that calls for a more muted response in interest rates to higher inflation than in the past – not only playing out but just getting started. We see central banks, notably the Fed, as likely leaning against sharp long-term yield rises. The upshot: We see a lower path of short-term interest rates compared with our previous expectation and current market pricing – and this has significant implications for our strategic views.

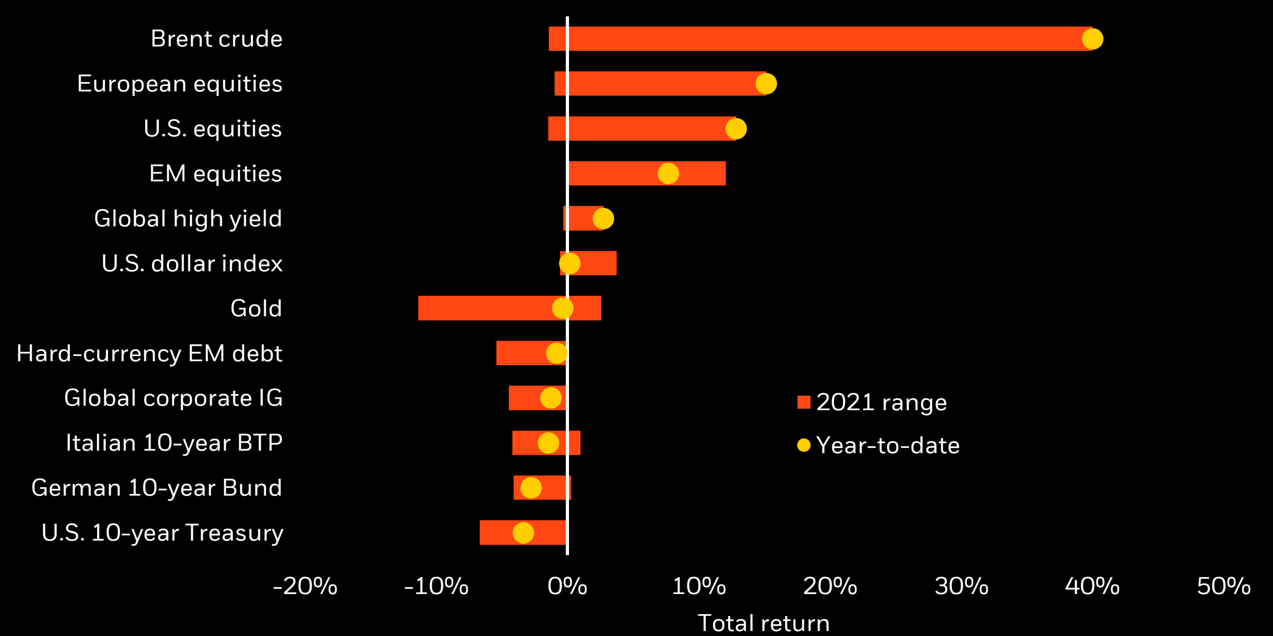
Our strong conviction on these long-term investment themes has helped inform our strategic views. These include a preference for assets that are likely to benefit from the climate transition, Chinese assets as core holdings, and a preference for inflation-linked bonds over nominal bonds. The direction of travel is clear, yet it is crucial to identify nearer-term opportunities along the path between now and then. Over the tactical horizon, we are pro-risk amid the broadening restart. The easy monetary policy and massive fiscal spending have triggered some concerns about asset price bubbles, but we see little evidence to date of systemic financial imbalances arising. We will reflect on the implications of the economic restart on asset classes and update our views in the upcoming midyear global outlook to be released on July 6.

Market backdrop

U.S. consumer prices jumped in May and key drivers appear related to the activity restart. Stocks rallied to record highs and bond yields fell. 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 Fed faces a very high bar to change its easy monetary policy stance.

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 June 10, 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.

Macro insights

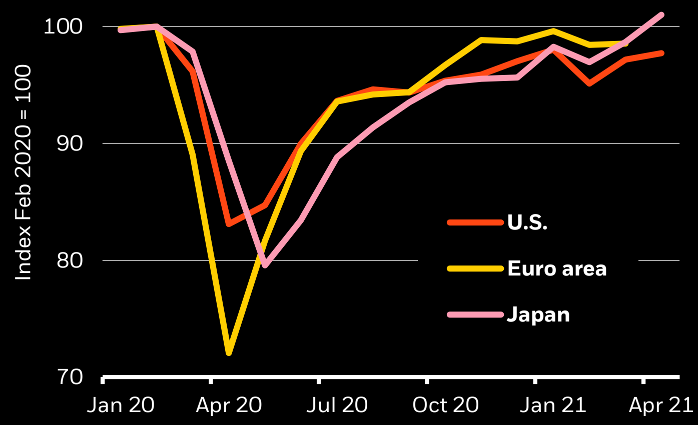
The economic restart is gathering pace in Japan. Industrial production has now surpassed pre-Covid levels – ahead of the U.S. and euro area, despite a later restart. See the chart. The country is also benefiting from strong foreign demand for machine tools on the back of growing investment spending.

The restart will likely be further boosted by a revival of consumer spending in the second half of the year – driven by the lifting of Covid restrictions amid lower cases and a broadening vaccine rollout, in our view. Moreover, consumer spending is likely to be more exuberant than cautious, due to pent-up demand, resilient domestic incomes and the excess savings built up during the pandemic.

Overall, Japan's cumulative loss in activity from the pandemic could be the smallest of all developed economies, and the country may reach pre-Covid growth levels before year end – ahead of Europe and the UK. Yet inflation is still lingering below target, meaning the Bank of Japan – which meets this week - will need to remain highly accommodative for the foreseeable future. See our macro insights hub.

Japan's restart gathers pace

Industrial production in the U.S., euro area and Japan



Sources: BlackRock Investment Institute, Federal Reserve Board, Eurostat, Japan METI, with data from Haver Analytics, June 2021. Notes: The chart shows industrial production by country, rebased to 100 at February 2020.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart – with the euro area catching up - 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 rise in nominal government bond yields this year is justified and reflects markets awakening to a strong, vaccine-driven activity restart combined with historically large fiscal stimulus.
- 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 a case for greater exposure to China-related assets for potential returns and diversification – and view them as core strategic holdings that are distinct from EM exposures.
- 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.
- Momentum is growing at the G20 for a global minimum tax that would reduce the ability of multinationals to shift profits to low-tax jurisdictions.
- **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.

Week ahead

June 15	U.S. retail sales and industrial production
June 16	Federal Open Market Committee policy meeting; China retail sales
June 17	U.S. Philly Fed business sentiment
June 18	Bank of Japan policy decision

Markets will focus on the Fed's policy meeting this week as investors watch for the central bank's reaction to strong inflation prints in recent months. We see the volatility in near-term inflation data as a result of the unusual supply and demand dynamics triggered by the economic restart, and expect the Fed to reiterate the transitory nature of the inflation spike and to stand by its new policy framework.

Directional views

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

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, 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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.
	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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee