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Weekly commentary

June 28, 2021

BlackRock

A taxing question for U.S. stocks

- The potential for higher U.S. taxes, coupled with regulatory risks and shifting growth momentum, tempers our near-term enthusiasm for U.S. equities.
- Euro area business activity surged in June as the region catches up on the restart that has been led by the U.S. and UK.
- Investors will focus on U.S. nonfarm payrolls this week to gauge how quickly the labor market is healing amid the economic restart.

We see equities in developed markets (DMs) outside the U.S. as better positioned to capture the economic restart over the tactical horizon, as the powerful restart broadens out. Potentially higher taxes and more regulations could pose challenges to the strong performance of U.S. stocks, yet we would expect the eventual tax increases to be less than proposed by the administration.

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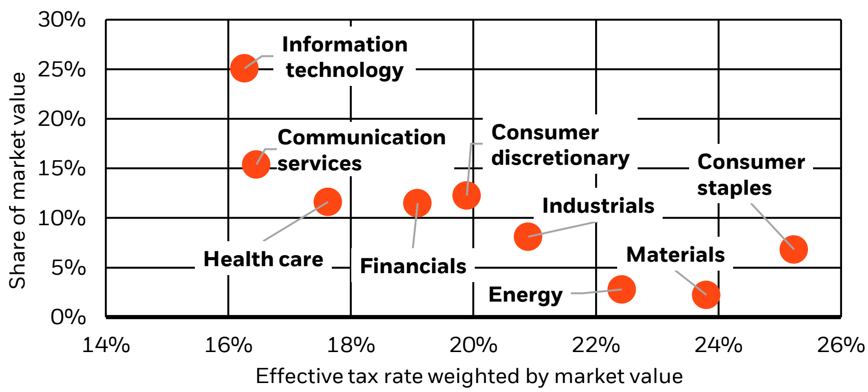
Chart of the week

U.S. equity sector effective tax rates and market value share, June 2021



Sources: BlackRock Investment Institute, with data from Refinitiv, June 2021. Notes: The chart shows the share of each sector on the total market capitalization of the S&P 500 Index, and each sector's market cap-weighted effective tax rate. Real estate and utilities are not shown on the chart. Each accounts for 2% of the total market value; real estate has an effective tax rate of 7% and utilities 13%.

The White House has signed on to a bipartisan infrastructure plan, a fraction of its original $4 trillion proposal that would be partially funded by higher taxes on corporations and high-income individuals. The U.S. has also endorsed a global minimum tax scheme, against the backdrop of an OECD initiative to tax cross-border digital services and limit multinationals from shifting profit to lower-tax jurisdictions. Higher taxes would have varied sectoral implications. Sectors with the lowest effective tax rates – or the actual rate paid after taking into account various tax breaks and deductions – have the most to lose, all else being equal. Information technology (IT), the largest sector on the S&P 500 Index, has a relatively low effective tax rate just under 17%. Energy, materials and consumer staples have tax rates above 20%. See the chart above. We see large-cap IT and healthcare – which typically benefit most from shifting profits to lower-tax jurisdictions – potentially taking the biggest hit to earnings if a global minimum tax is enacted. Tax increases less than proposed by the administration - our base case – could soften the blow. Relatively high profit margins and supportive structural growth trends in these sectors would help offset such risks, in our view.

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Uncertainties abound on the administration's tax plan despite last week's bipartisan deal. This deal may still face hurdles in Congress, and there will likely be a larger package of spending and tax increases that Democrats would have to push through Congress unilaterally. A thin Democratic majority in Congress, conflicting priorities within the Democratic Party, and the looming 2022 midterm elections all pose challenges. We expect the eventual spending plan to be well below the price tag with less offsetting tax hikes than initially proposed. If the proposed 28% corporate income tax rate and a 21% global minimum tax were imposed, we estimate the earnings per share of the S&P 500 Index would be 7% lower in 2022 compared with a scenario without tax increases. A more moderate increase would have a smaller impact on earnings. Already, President Biden has signaled a willingness to consider a more moderate increase in the top corporate tax rate to 25%. The increase in the capital gains tax on high-income individuals will also likely be smaller than proposed, and any increases may be subject to reversal when political winds shift, in our view.

The U.S. has led the developed world's economic restart – together with the UK – and its growth looks to be peaking as the restart broadens out. We see the potential for other DM markets, such as Europe and Japan, to pick up the baton and benefit more from the restart trade. These markets, which already have higher taxes and more regulations than the U.S., face more limited scope for additional taxes and regulation, in our view.

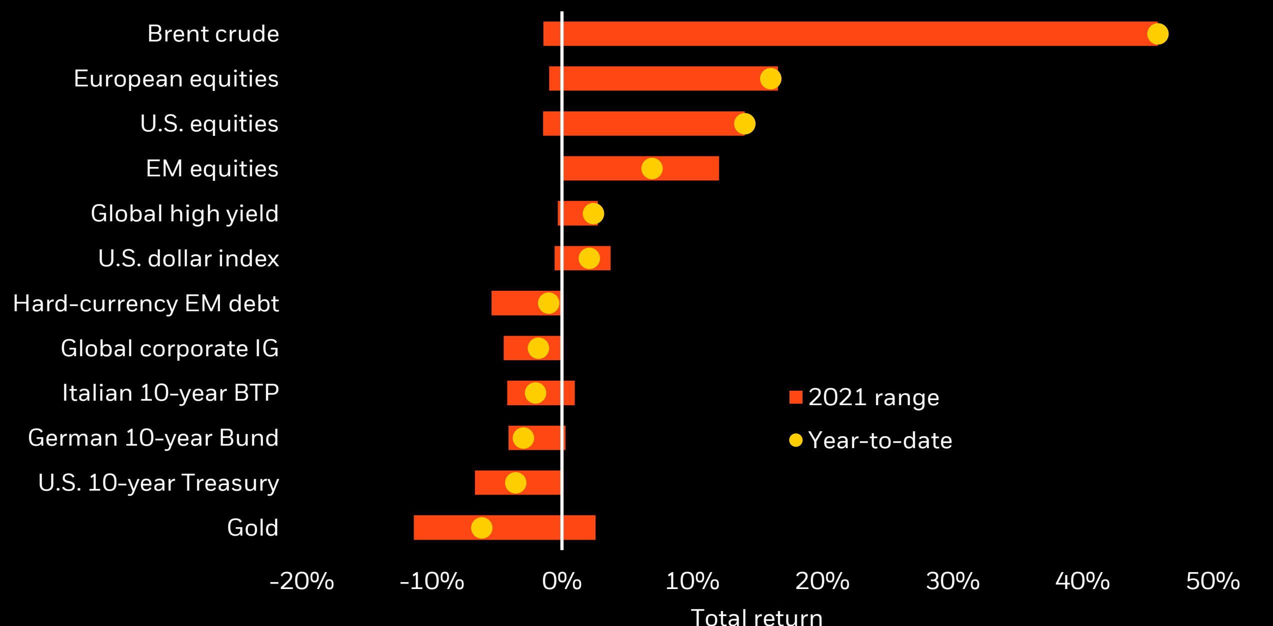
The bottom line: Uncertainties around potential tax increases are making it hard for investors to position for the potential impact for now. We see U.S. equities potentially coming under pressure from higher taxes and other factors, but still like small- and medium-cap U.S. companies as tax increases and regulations targeting large multinational companies are less likely to affect them. Higher taxes on individual capital gains could lead to a greater focus on after-tax portfolio construction, potentially driving up demand for tax-efficient strategies that allow taxable investors to better control the timing of their capital gains, including exchange-traded funds (ETFs) and managed accounts, in our view. Tax-advantaged U.S. municipal bonds may also benefit from increased demand, even as their valuations look relatively rich to us.

Market backdrop

Euro area business activity accelerated at its fastest pace in 15 years in June as broadening vaccinations drive the economic reopening, last week's purchasing managers' index (PMI) data showed. The euro area has been catching up on the economic restart after the U.S. and UK have led it this year. Federal Reserve Chair Jerome Powell said the Fed would not rush to raise interest rates on inflation fears alone, after Fed officials embraced higher 2021 inflation as contributing to their policy objectives and opened the door to a 2023 lift-off of policy rates.

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 June24, 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), 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, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

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Macro insights

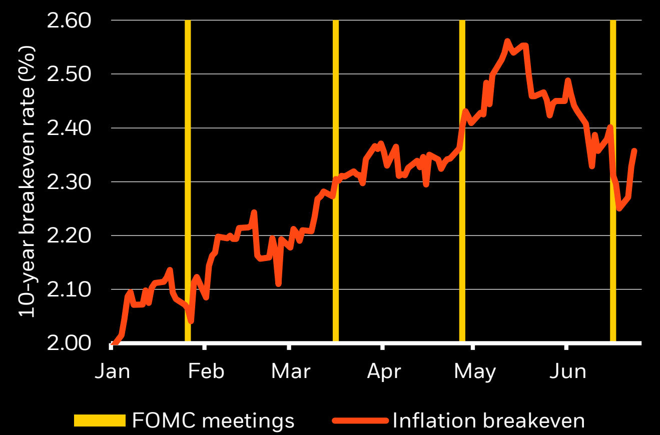
Federal Reserve officials surprised markets earlier this month by embracing higher inflation and heralding a lift-off of rates in 2023, rather than 2024. The market response – in particular in breakeven inflation rates – underscores the essential role that clear communication plays in boosting the credibility of the Fed's new framework.

Ten-year breakeven inflation – a market-implied measure of inflation expectation - tumbled to the lowest level since March after the Fed news. See the chart. This suggests that investors interpreted the Fed's signal as a move out of step with its new framework that aims to deliver moderately above-target inflation for some time. Investors were keen to price in a pace of rate increases we would see under the Fed's old framework, not the new one, in our view.

We believe the Fed remains committed to its framework, but see the need for greater clarity around how the framework works. Case in point: Last week a number of Fed speakers reasserted their dovish policy stance – and breakeven inflation recovered substantially. See our macro insights hub.

Say what now?

U.S. 10-year breakeven inflation rate, January-June 2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, June 2021. Notes: The breakeven inflation rate represents a measure of expected inflation and implies what market participants expect inflation to be in the next 10 years, on average. The yellow lines mark this year's Federal Open Market Committee (FOMC) meetings.

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.
- Fed officials in June projected higher inflation and moved up the lift-off in policy rates to 2023. We believe this confirmed our new nominal theme – that interest rates will rise more slowly than in the past in response to higher inflation – as the Fed's acknowledgement of rising price pressures has not translated into projections for significantly higher interest rates any time soon.
- 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.

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Week ahead

June 29	U.S. consumer confidence	**July 1**	China Caixin manufacturing PMI
June 30	China official manufacturing PMI; euro area flash inflation	**July 2**	U.S. nonfarm payrolls

Markets will closely watch the U.S. jobs report this week to gauge how quickly the labor market is healing amid the economic restart. Vaccination-driven reopening is starting to lift output especially in services, but short-term labor market bottlenecks may lead to volatility in month-to-month data. We advocate looking through near-term market volatility and remain pro-risk, predicated on our belief that the Fed faces a high bar to change its easy monetary policy stance.

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.

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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.

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