Weekly commentary

BlackRock.

September 7, 2021

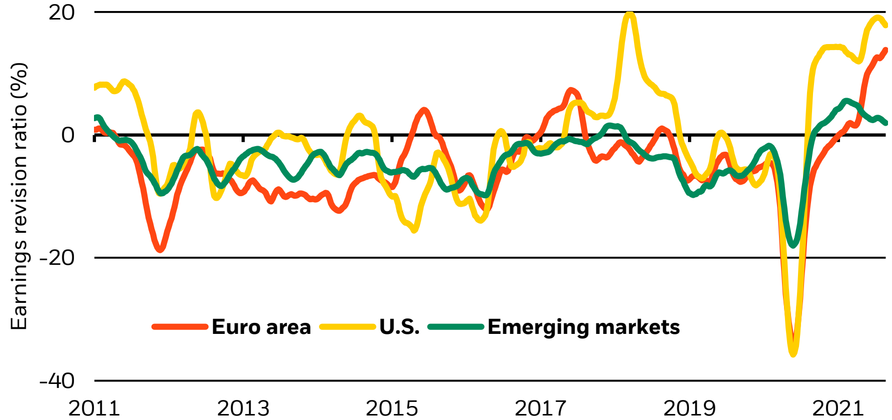
Spotlight on Europe

- We stay tactically overweight European equities with two key events on the horizon: a European Central Bank (ECB) meeting and the German election.
- U.S. jobs growth in August was far below expectations. Yet we caution that seasonality could be at play and a revision upwards is possible.
- An ECB policy meeting is expected to show persistent below-target inflation, implying a need for the central bank to contemplate further easing measures.

Europe is in the spotlight this month, with a key European Central Bank (ECB) meeting and a pivotal German election that could have significant medium-term implications for the fiscal stance of Europe's largest economy. We see the ECB's forecast revisions reaffirming inflation will likely stay below target in the medium term, requiring further policy support. Coupled with a broadening economic restart, this supports our tactical overweight stance on European equities.

Euro area earnings momentum

Earnings revision ratios: Euro area vs. U.S. and EM, 2011-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Bloomberg, August 2021. Notes: The chart shows a three-month moving average of earnings revisions ratios – or the ratio of corporate earnings upgrades to downgrades for each region shown. The three markets are represented by the MSCI EMU Index, MSCI USA Index and MSCI Emerging Markets Index.

The economic restart has been broadening beyond the U.S. – aided by an acceleration in vaccine rollouts, particularly in Europe and the rest of the developed world. This has supported a sharp rise in European corporate earnings revisions from last year's trough. Earnings revision ratios – the ratio of the number of stocks with corporate earnings upgrades to those with downgrades – are still on the rise in Europe, just as the ratio looks to be stalling in the U.S. (from high levels) and has already been trending lower in emerging markets. See the chart above. This shift in momentum lies behind our recent tactical upgrade in European equities to overweight, and our neutral stance on U.S. equities. Against this backdrop, the ECB meets this month in its second policy meeting since the central bank adopted a new policy framework. We expect the central bank to reinforce a low-inflation outlook for the medium term, paving the way for additional easing in 2022 and further supporting our tactical preference for euro area equities.

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Martin Lueck
Chief Investment Strategist for Germany, Austria, Switzerland and Eastern Europe – BlackRock Investment Institute

Nicholas Fawcett
Member of the Economic and Markets Research Team– BlackRock Investment Institute

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BlackRock **Investment** Institute

The ECB may choose at its September meeting to reduce the pace of asset purchases under its pandemic emergency purchase program (PEPP). The backdrop: easier financing conditions, especially with lower bond yields. Yet concerns that global financial conditions may tighten later this year around the likely start of the Fed's taper of its asset purchases might persuade the ECB to leave the pace unchanged. In any case, we see this as an operational decision – and not one sending a signal about future policy. The central bank may lift its near-term growth and inflation forecasts, but we expect its outlook to show inflation remaining far below the ECB's target over the medium term. Unlike the Fed, the ECB has not switched to target average inflation. This means any near-term overshoot of its inflation target – such as the recent upside surprise in the flash August print for euro area inflation – should not affect future policy decisions: The central bank will let inflation bygones be bygones. The weak medium-term inflation outlook implies that the ECB will need to step up its asset purchase program after the pandemic-era PEPP – which will run at least until March 2022 – expires.

The German election later in the month will be the first in a series of key elections in Europe that may be decisive in shaping the future of the region. It could have important medium-term implications for the country's fiscal stance, business environment and plans to deal with climate change. The election looks to be wide open, with the Social Democratic Party (SPD) recently overtaking Angela Merkel's conservative Christian democratic alliance (CDU/CSU) in a major poll for the first time in 15 years; and the process of forming a governing coalition could be drawn out. We do not see a repeat of euro crisis-style austerity as likely, not least because the Stability and Growth Pact (SGP) is suspended until 2023. Yet Germany's fiscal stance could become more restrictive if a center-right coalition were to prevail. A more conservative fiscal stance in Germany could complicate matters for Europe if monetary policy alone is not enough to bring low inflation back up to target.

Bottom line: We see the ECB meeting this week paving the way for additional easing measures after the end of its PEPP. We also believe investors should be on the lookout for the longer-term policy implications of a new governing coalition in Germany, particularly on fiscal policy. We recently upgraded European equities to overweight on the back of the broadening restart helped by accelerating vaccinations. Valuations remain attractive relative to history and look even more attractive than at the start of the year thanks to strong earnings; investor inflows into the region are only just starting to pick up. We are neutral on German bunds and peripherals.

Market backdrop

U.S. jobs growth slowed sharply in August. Yet seasonality could be at play and an upward revision is possible, in our view. We also caution against extrapolating too much from near-term data amid unprecedented restart dynamics. U.S. equities softened after the disappointing jobs data, but still held near the record high hit earlier in the week. Fed Chair Jerome Powell reassured markets at the recent Jackson Hole symposium, making no announcement on tapering as we expected but giving a strong signal that one will come before year-end if employment gains keep up.

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 Sept. 2, 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, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), J.P. Morgan EMBI Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

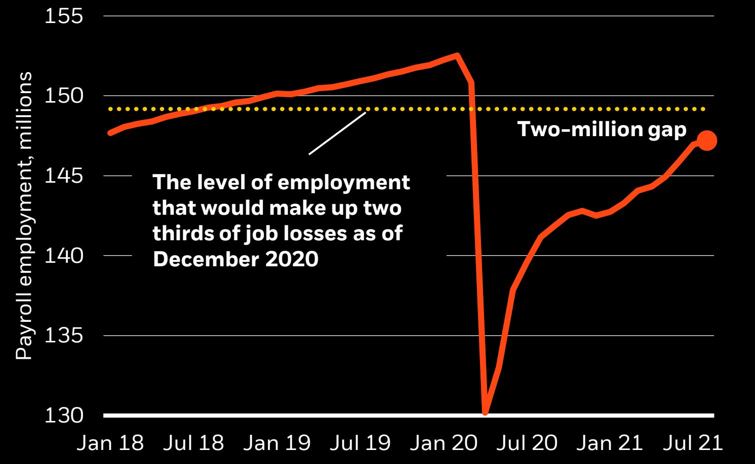
The Federal Reserve has made the start of asset purchase tapering conditional on having achieved "substantial further progress" on its inflation and employment goals. With Chair Jerome Powell acknowledging that this condition has been met for inflation, the last hurdle is employment.

August payroll data released last Friday showed a 235K gain. Although far below expectations, seasonality could be at play and a revision upwards is possible. In any case, the increase is a step toward making up two-thirds of job losses outstanding in December 2020 – the level some FOMC participants have indicated could be sufficient to represent substantial further progress in employment. See the chart. Strong readings in September and October could put the Fed in a position to make an announcement on tapering in November – not impossible given the end of the unemployment benefits top-up next month, in our view.

The Fed has emphasized that tapering is not a direct signal about a lift-off in policy rates, which we still don't expect before 2023. See our macro insights hub.

Jobs recovery paves way for taper

Total non-farm payrolls, 2018-2021



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Refinitiv Datastream, September 2021. Notes: The orange line shows total U.S. nonfarm payrolls. The yellow dotted line shows the level of employment that would make up two thirds of job losses as of December 2020, and the orange dot indicates the latest nonfarm payrolls data – about two million jobs below that level.

Investment themes

1 The new nominal

- The powerful economic restart is broadening, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- We expect the Fed to start normalizing policy rates in 2023, a much slower pace than market pricing for lift-off in 2022 indicates. Fed Chair Jerome Powell reassured markets at the recent Jackson Hole symposium, making no announcement on tapering but giving a strong signal that one will come before year-end if employment gains keep up. He also made clear that tapering "will not carry a direct signal" with respect to a lift-off in policy rates.
- The ECB tweaked its forward guidance after having recently set its inflation target at 2% in the medium term but rejecting an average inflation targeting framework. The central bank said it would keep policy rates on hold until it had seen "inflation reaching 2% well ahead of the end of the projection horizon and durably for the rest of the projection horizon."
- **Tactical implication**: We go overweight European equities and inflation-linked bonds. We cut U.S. equities to neutral.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is already a distinct pole of global growth. We believe it is time to also treat it as an investment destination separate from EM and DM.
- Chinese authorities have started loosening policies as growth slows, yet we believe they will maintain the broadly hawkish policy stance over the medium term to stay focused on the quality of the growth.
- We believe the clampdown on some private industries could go on for years, but its intensity would likely fluctuate. We have yet to see the peak of the regulatory campaign, but could see its pace and intensity to moderate amid slower growth.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We break out China from EM with a neutral stance on equities and an overweight to debt.
- **Strategic implication:** Our neutral allocation to Chinese assets is multiples larger than typical benchmark weights.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of prices of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

Sept 6	German industrial output and orders
Sept 7	German ZEW sentiment; China trade data
Sept 9	ECB policy decision
Sept 10–16	China total social financing data

Markets will focus on the ECB policy decision on Thursday. We believe the new ECB framework implies not only lower rates for longer, but also additional support via asset purchases. China's total social financing data will be key to gauge the fiscal impulse and activity slowdown. Chinese authorities are likely to remain hawkish in the medium term, but we see a dovish shift in the near term as economic growth has been losing momentum.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	We keep our 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 indices. 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 quality bias.
Credit	**-1**	**Neutral**	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	**-1**	**-1**	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballast with yields near lower bounds. 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 – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		**Neutral**	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
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 and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, September 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, September 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We are overweight European equities on the back of the broadening restart. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			While overweight on a strategic basis, we see near-term risks. Growth is slowing at the same time as policy stance is tight – and may not respond in a timely way as authorities focus on the quality of growth. The anti-monopoly clampdown is ongoing.
Equities	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. The anti-monopoly clampdown in the heavyweight Chinese tech sector and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries, primarily on valuations. We see the balance of risks tilting toward gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We initiate a view on Chinese government bonds with an overweight. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We remain underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield credit after the asset class' strong performance. Spreads are now below where we see high yield as attractively valued. We prefer to take risk in equities.
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. and see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring, in our view.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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