Weekly commentary

BlackRock

October 11, 2021

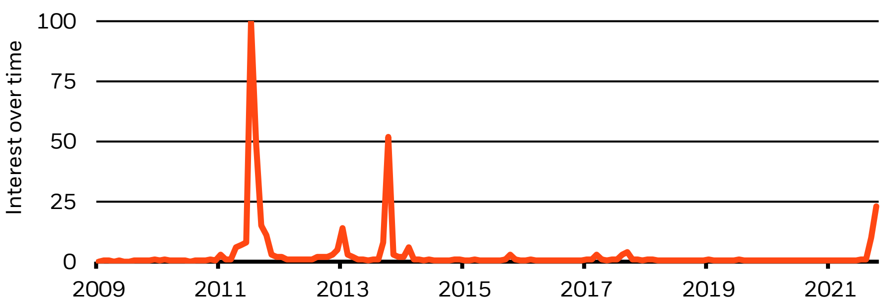
Debt ceiling spat takes a breather

- We believe the debt ceiling dispute will eventually resolve but could trigger more volatility. The broadening economic restart keeps us tactically pro-risk.
- U.S. job growth slowed sharply in September, but we see it as unlikely to affect the Fed’s taper plan. The Senate reached a deal on a temporary debt ceiling rise.
- U.S. inflation data will be in focus as price pressure has appeared to be more persistent than expected and broadened beyond pandemic-related items.

We still see a low risk of technical default by the U.S. and expect the debt ceiling debacle to ultimately resolve. The broadening economic restart keeps us tactically pro-risk, yet we see a narrowing path for risk assets to push higher and markets more prone to temporary pullbacks. Key events toward the year end, including the lapse of the temporary debt ceiling rise, could potentially trigger market volatility. We favor looking through market jitters against the backdrop of the restart.

Search for the debt ceiling

Google searches using the key phrase “debt ceiling,” 2009-2021



Sources: BlackRock Investment Institute, with data from Google, October 2021. Notes: Interest over time shows search interest relative to the highest point on the chart for the given time, according to Google. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular. A score of zero means there was not enough data for this term.

The showdown around the debt ceiling – a self-imposed federal borrowing limit - has kept investors on their toes. The debt ceiling has become a subject of intense partisan wrangling over recent decades, with negotiations going down the wire in 2011 and 2013. Google searches on the key phrase “debt ceiling” have surged to the highest level since the 2013. See the chart above. In recent months the impasse has led to market jitters, especially after risk assets have had an extended run higher. The front end of Treasury yield curve – a popular gauge of market sentiment on the issue – had shot up until the Senate struck a deal to temporarily raise the debt ceiling last week. Yet there is more political squabble to come toward the year end. The U.S. government could once again near a technical default around the time when the temporary government funding is set to lapse if Congress fails to approve new spending legislation and raise the debt ceiling. Democrats have yet to unify behind their multi-trillion-dollar spending plans on infrastructure, social policy and climate change.

Wei Li

Global Chief Investment Strategist – BlackRock Investment Institute

Elga Bartsch

Head of Macro Research – BlackRock Investment Institute

Kurt Reiman

Senior Strategist for North America – BlackRock Investment Institute

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The temporary debt ceiling increase will likely allow the Democratic Party to focus on rallying its members in Congress around the spending plans – key legislative priorities ahead of the 2022 midterm elections. As expected, the $3.5 trillion price tag of the bill on social policy and climate change is being scaled down to help ensure the support of party moderates.

A smaller package means a reduced amount of revenue needed to offset spending. The tax proposals from the House Ways and Means Committee prior to the latest effort among Democrats to scale down the plan already showed moderated tax increases. This includes a proposed rise in the corporate tax rate to 26.5%, down from 28% in the original proposal. It also showed an increase in the Global Intangible Low Tax Income (GILTI) tax – intended to discourage corporations from moving profits overseas – to 16.5%, down from 21%. This increase would be line with the new global minimum tax agreement that aims to achieve the same goal. We are tactically neutral U.S. equities as we see large caps as exposed to risks of higher taxes and tighter regulation. The tax increases will likely have the largest impact on financials and communication services, in our view, but any further watering down of the proposed tax increases would reduce the headwind for these sectors.

The debt ceiling debate recently has triggered headlines and volatility, and we believe markets generally are increasingly susceptible to swings in sentiment. This includes supply-driven price spikes in energy and other prices awaking fears of runaway inflation and central bank actions to suppress it. We see the price spikes as mostly related to the powerful economic restart and therefore not permanent, but recognize inflation narratives can easily take hold of markets.

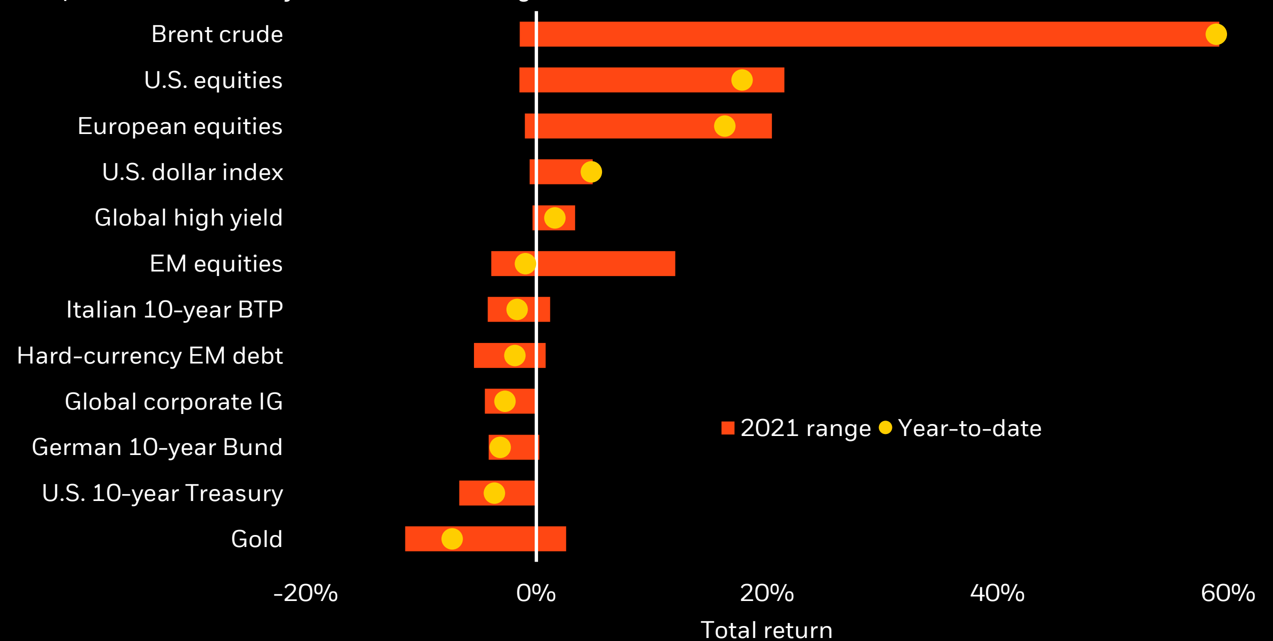
The bottom line: We continue to see a low risk of a technical default by the U.S. government, and expect a downsized spending package and related tax increases. The debt ceiling showdown may return in December, yet we believe it will ultimately be resolved and prefer to look through potential market volatility. Political brinkmanship could lead to a short-lived government shutdown and reignite concerns of a technical default. We are tactically neutral U.S. equities as we see U.S. growth momentum peaking and expect other regions to benefit more from the broadening economic restart. We are strongly underweight U.S. Treasuries as we see a gradual rise in nominal yields even with the Fed poised to start tapering by the end of the year. We are tactically pro-risk, yet recognize the path for further gains in risk assets has narrowed after an extended run higher and that markets have become more susceptible to sentiment swings.

Market backdrop

U.S. nonfarm payrolls growth slowed sharply in September due to the delta variant surge. U.S. stocks reversed the previous week's decline after the Senate agreed to temporarily raise the debt ceiling. U.S. 10-year Treasury rose to the highest level since June. We view the recent yield backup as correcting a disconnect between the restart and earlier yield levels, rather than foreshadowing a more drastic yield rise. Stronger-than-expected activity data and more hawkish signals from policymakers have shifted the market consensus on the Bank of England's interest rate liftoff to the first quarter of 2022.

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 Oct. 7, 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, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, J.P. Morgan EMBI 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

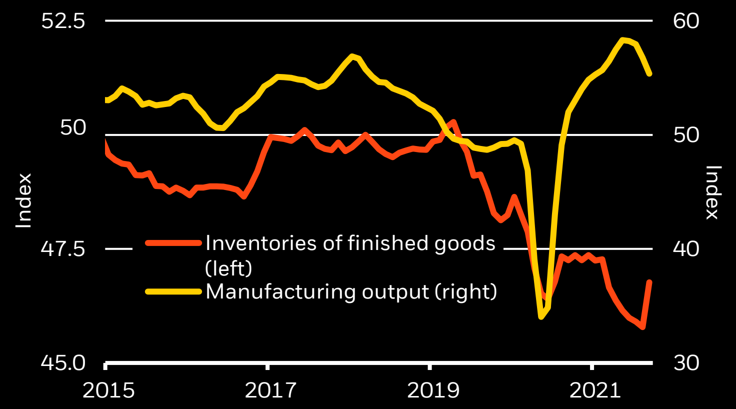
Many manufacturing companies experienced a surge in demand for goods at the start of the pandemic as people shopped online, while at the same time production became more difficult or was halted altogether. This supply/demand imbalance resulted in a sharp drop in inventories of finished products then. See the chart.

Even when production began to normalize as global economies restarted, demand continued to surge. Supply has remained constrained due to severe disruptions in global shipping and labor shortages, especially in the U.S. That said, the pace of inventory decline has slowed in the latest data – suggesting that the contribution to activity growth might turn positive, in our view.

Though current supply disruptions will likely persist into next year, ultimately we see production recovering as companies not only respond to higher demand but also seek to build stocks back up to above pre-Covid norms to have a bigger buffer in case of future shocks. See our macro insights hub.

Emptying the pantry

DM manufacturing PMI output and inventories, 2015-2021



Sources: BlackRock Investment Institute, with data from Haver Analytics, October 2021. Note: The chart shows the Markit PMI Manufacturing Stocks of Finished Goods Index (orange) and Manufacturing Output Index (yellow line) for developed markets on a rolling three-month basis. A reading above 50 indicates more firms with rising inventories for the former and more firms with expanding output in the latter, and a sub-50 reading suggests more firms with falling inventories and contraction in manufacturing output respectively.

Investment themes

1 The new nominal

- The powerful restart of economic activity has broadened, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term. We see the Fed normalizing policy rates only in 2023 and the European Central Bank standing pat for much longer.
- *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.
- The Fed has signalled that it is gearing up to start tapering around the end of the year. It appears reluctant to confirm its inflation mandate has been met, and this reinforces our *new nominal* theme.
- The ECB has made a significant change to its monetary policy framework by adopting a symmetric inflation target of 2%. We believe this is part of a global trend to relax the constraints in earlier frameworks preventing looser policy.
- **Tactical implication**: We are overweight European equities and inflation-linked bonds. We are neutral on U.S. equities. We upgrade EM local-currency debt to modest overweight.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is on the path toward greater role of state where social objectives will have primacy over quantity of growth. Yet the growth slowdown has hit levels policymakers can no longer ignore and we expect to see incremental loosening across three pillars - monetary, fiscal and regulatory.
- 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 turn modestly positive on Chinese equities, and maintain an overweight on its debt.
- **Strategic implication:** Given the small benchmark weights and typical client allocation to Chinese assets, allocation would have to increase by multiples before they represent a bullish bet on China, and even more for government bonds.

3 Journey to net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today.
- The full consequences of the tectonic shift to sustainability are not yet in market prices, in our view. 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 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

Oct. 11-18	China total social financing and new yuan loans	**Oct. 14**	U.S. producer price index (PPI); China CPI, PPI
Oct. 13	U.S. consumer price index (CPI)	**Oct. 15**	University of Michigan Surveys of Consumers

U.S. inflation data will be in focus this week. Consumer prices increased at their slowest pace in six months in August as prices of some items related to the Covid shock had subsided, though inflationary pressure had broadened beyond pandemic-related items. Consensus forecast sees a 5.4% annual increase, compared with a 5.3% rise in the previous month, according to Reuters.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 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 ballasts 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, October 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.
	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.
	Europe			We stay overweight European equities on the back of a strong growth backdrop. 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.
	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European 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.
	China			We are modestly positive to upgrade Chinese equities to overweight as we see a gradual dovish shift in monetary and fiscal policy in response to the cyclical slowdown and anticipate that the regulatory clampdown will become less intense.
	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.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. Potential knock-on effects from slower growth in China 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 is for gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
	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.
	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.
	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.
	China government bonds			We are overweight Chinese government bonds. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
	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 Asian fixed income.
	Global high yield			We are neutral high yield after the asset class' strong performance. Spreads are now below where we see high yield as attractive valued. We prefer to take risk in equities.
	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 modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and carry in a world starved for 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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