Weekly commentary

BlackRock.

December 6, 2021

Three investing lessons of 2021

- Our key lessons of 2021: Stay anchored to your framework in the unique restart; appreciate the net-zero journey has started; and have courage of conviction.
- Markets switched to risk-off mode last week as the Omicron virus strain spread globally and the Fed warned of inflation risks and ending asset purchases early.
- U.S. CPI data will give investors a read on the strength and drivers of the inflation surge that has prompted the Fed to gradually start normalizing policy.

As 2021 draws to a close, we draw three lessons. First, you need a compass to navigate the unique backdrop of a noisy restart of economic activity. Ours was the *New nominal*: The policy and market response to inflation would be historically muted. Second, realize that the journey for the world to reach net-zero emissions by 2050 is starting *now.* Third, have courage of conviction. We didn't always have it. We had conviction the *New nominal* was real, but didn't put enough risk behind it.

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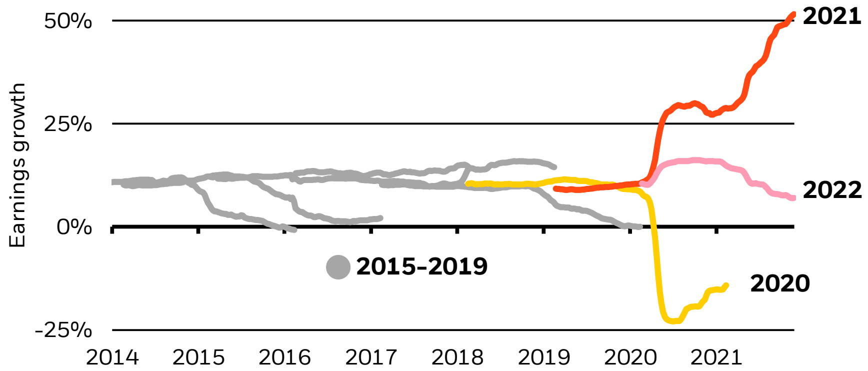
It's a restart, not a recovery

MSCI AC World equity earnings growth estimates, 2014-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2021. Notes: chart shows the path of aggregate analyst earnings growth estimates for each year since 2015.

2021 has been marked by a confluence of events that have no historical parallel: a unique growth surge, a supply-driven spike in inflation and new central bank frameworks that are stress-tested in real time. Our anchor to interpret this macro environment has been that normal business cycle logic does not apply. The COVID-19 shock was more akin to a natural disaster, followed by a powerful restart of economic activity. This restart is nothing like the long, grinding recovery following the 2008-2009 financial crisis. It's more like the world turned the lights back on. Economic activity surged, corporate profits rebounded at an astonishing pace in the restart, and developed market (DM) equities ripped. The chart shows how analysts have scrambled to upgrade their earnings forecasts to a 52% jump in 2021 (the red line). We had long warned of higher inflation after decades of disinflation. Inflation is here now. It's being driven by supply bottlenecks coupled with unusually strong household spending on goods, rather than services. We expect it to settle at higher levels than pre-COVID even as pressures from supply bottlenecks ease. In the past, central banks would already have started to raise policy rates, and bond yields would have spiraled upward. Not this time.

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Many central banks were content to let inflation run higher, and bond yields moved up only modestly relative to the inflation picture. The *New nominal* theme helped foretell this unusually muted response to rising inflation, and was the compass that has guided us throughout the year. The Fed last week belatedly acknowledged inflation risks, and we expect it to start raising rates next year. That's a big change, but what matters are the rate trajectory and destination. We don't see rates going as high as they would have historically in the next phase of the *New nominal*.

The second investing lesson of 2021: the transition to a more sustainable world is happening now, not at some distant point in the future. First, surging fossil fuel prices in 2021 have exposed a lopsided transition toward low-carbon power. We still see an orderly transition in the medium term – but with bumps on the way leading to growth and inflation volatility. But we think inflation pressures would be even more acute and growth lower in case of a disorderly transition or no-climate-action scenario. Second, the tectonic shift toward sustainable investing is already playing out, and we believe this will give sustainable assets a return advantage for years to come. Climate-driven repricing has already started, we believe, with carbon-efficient sectors able to lower their cost of capital. Lastly, carbon-heavy companies are not waiting for new climate policies but are changing their business models now, opening up selected investment opportunities.

Our third lesson of 2021 is having courage of conviction. Our macro framework – the *New nominal* playing out in the restart – kept us positive on equities and underweight government bonds throughout the year. But we did not put enough risk behind our view in hindsight, even considering this has been a tricky environment where things can change quickly. Having courage of conviction is not about adding risk per se, it is also needed when your framework tells you it's time to pull back on risk-taking. The speed and magnitude of some market moves also surprised us. An example: the swings in 10-year U.S. Treasury yields as different market narratives on growth, inflation and the virus took hold in quick succession.

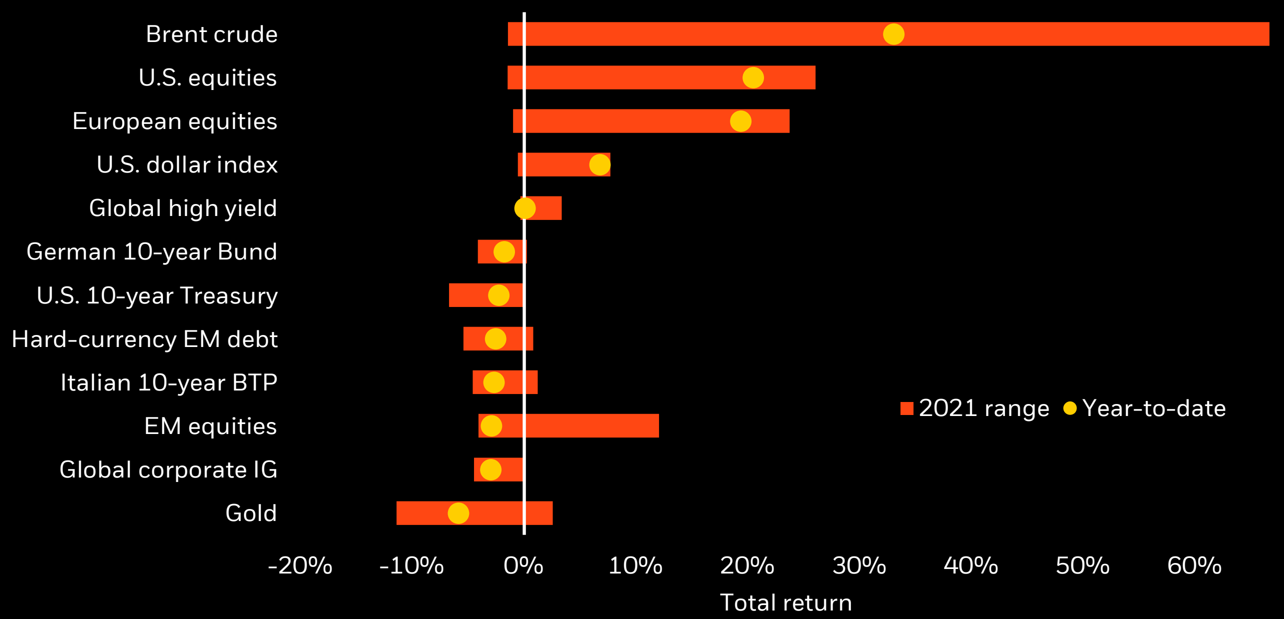
Where does all of this leave us heading into 2022? We are still overweight equities even as the Omicron virus strain and the Fed's catching up to inflation reality have hurt risk sentiment. We expect new virus variants to delay, but not derail, the restart and see policy rates rising only modestly in the *New nominal*'s next phase. Our 2022 Global outlook will lay out the full picture next week, including refreshed granular views for tactical and strategic asset allocation.

Market backdrop

Markets suffered a risk-off bout as the Omicron virus strain spread, and Fed chair Jerome Powell warned of inflation risks in the restart and indicated the Fed may wrap up its asset purchases earlier than planned. We expect the Fed's interpretation of its employment objective to set the timing of the kick-off on rates and their pace. We see inflation settling at a level higher than pre-COVID even as pressures from supply bottlenecks ease, as we expect a muted policy response to inflation.

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 Dec. 3, 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), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, spot gold, 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 and Refinitiv Datastream U.S. 10-year benchmark government bond index.

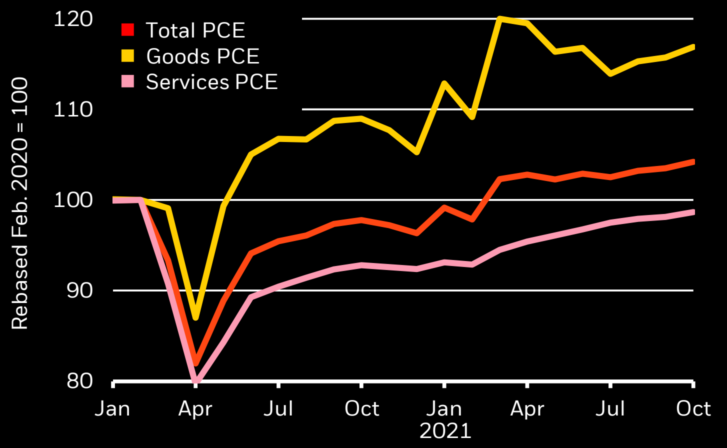
Macro insights

U.S. consumer spending strengthened in October and now is more than 4% above its pre-Covid peak. But there is still a big gap between goods and services. Spending on goods passed its pre-Covid peak as early as June 2020, while spending on services has only slowly climbed back up and is still below its pre-pandemic level. See the chart. Our conclusion: The economic restart has room to run.

Will the emergence of the Omicron virus variant knock back spending? This will depend on its transmissibility and its ability to evade vaccines. This will determine whether we'll see renewed lockdown measures or a change in consumer behaviors. If vaccines remain effective or can be altered swiftly, we expect the restart to be only delayed, not derailed. Less spending now means more later. A delay, however, could mean supply-side bottlenecks intensify or last longer. The mismatch of supply and demand has been a major driver of inflation, so a restart delay could result in inflationary pressures persisting longer. See our macro insights hub.

A strong U.S. consumer

U.S. real personal consumer expenditure levels, 2020-2021



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, using data from Haver Analytics, November 2021. Note: The chart shows the level of real personal consumer expenditure, distinguishing between total PCE (orange line), goods (yellow) and services (pink). Lines are indexed to the level of real spending in February 2020 = 100.

Investment themes

1 The new nominal

- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve next year. We see inflation as persistent into 2022, moderating from today's elevated levels to settle at higher levels than before COVID.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation, even as the Fed has started to warn of inflation risks. Other developed market central banks have signaled policy rate paths with steeper initial increases.
- The Fed has started tapering bond purchases by $15 billion a month and indicated it may speed up this timeline. The central bank has achieved its new inflation goal to make up for past misses; the key now is how it interprets its more ambitious full employment mandate.
- We expect the Fed to start raising interest rates next year – if not as soon as the market pricing. But what matters is the policy rate trajectory, not just the first hike. We expect the most muted policy response to inflation in decades.
- **Tactical implication**: We prefer equities and inflation-linked bonds, and are underweight U.S. Treasury bonds.
- **Strategic implication**: We are underweight DM government bonds and prefer equities over credit.

2 China stands out

- China has emphasized social objectives and quality growth over the quantity of growth in a series of regulatory crackdowns that have spooked some investors. Yet a 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 the ongoing U.S.-China strategic competition, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We are modestly positive on Chinese equities and are overweight government bonds.
- **Strategic implication:** We believe global investors should raise their allocations to Chinese assets for potential returns and diversification, given the small benchmark weights and typical client allocation to Chinese assets. Allocations would need to increase significantly before they reflect a bullish view, in our opinion.

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 net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs, yet the economic outlook is unambiguously brighter than a scenario of no climate action.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions. Policy remains the main tool. Some carbon-heavy companies already are changing their business models, independent of regulatory and political outcomes, creating potential investment opportunities.
- We see sustainability-driven repricing as having just begun – with accelerating flows into ESG products a big driver.
- Commodities such as copper and lithium will likely see increased demand from the drive to net zero. It's important to distinguish between near-term drivers of commodities prices – the economic restart – and the long-term transition.
- **Tactical implication**: We see opportunities in companies rapidly adapting their business models for net zero.
- **Strategic implication**: We like DM equities and the tech sector as beneficiaries of the climate transition.

Week ahead

Dec. 7	U.S. and China trade data
Dec. 9	China PPI and CPI
Dec. 10	U.S. CPI and University of Michigan sentiment; UK GDP estimates; China money and credit data

U.S. inflation data are the key focus this week, especially after the Fed has caught up to inflation reality and warned of inflation risks last week. The Fed's inflation target has been met, so now the key is how the central bank will interpret the other side of its mandate – full employment. The timing and trajectory of rate rises will depend on this. We see the rate path as historically shallow. U.S. and China trade data may give a read on how fast supply-demand imbalances are dissolving.

Directional views

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

Change in view Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	We are overweight equities on a strategic horizon amid fair valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we are overweight equities amid solid economic growth and historically low real rates.
Credit	**-1**	**Neutral**	We are underweight credit on a strategic basis. 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. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. Tactically, we are also underweight government bonds on expectations of gradually rising yields.
Cash		**Neutral**	We keep some cash to potentially 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, December 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, December 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and see other regions as more attractive to capitalize on the next leg of the restart of economic activity.
Equities	U.S. small caps		■	We are 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.
Equities	Europe		■	We are overweight European equities amid a sizeable pickup in economic activity. Valuations look attractive, and investor inflows into the region are 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.
Equities	China		■	We are modestly positive on Chinese equities as we see a gradual dovish policy shift to fend off a slowdown. We expect the regulatory clampdown to last but lessen in intensity.
Equities	Emerging markets			We are neutral EM equities. Many EM central banks have raised rates in the face of inflation, dampening growth and tightening financial conditions.
Equities	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. Risks are tilted toward gradually higher yields as markets price in the economic restart.
Fixed Income	Treasury Inflation-Protected Securities		■	We are overweight U.S. TIPS amid high inflation in the near term. TIPS look attractive versus European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. We see little room for a substantive change in monetary policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	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.
Fixed Income	Global investment grade	■		We are underweight investment grade credit. We see little room for further yield spread compression.
Fixed Income	Global high yield			We are neutral high yield. High yield spreads no longer provide attractive value. 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 modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and coupon income in a world starved for yield.
Fixed Income	Asia fixed income		■	We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield given the region's fundamental outlook.

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