Weekly commentary

BlackRock

October 4, 2021

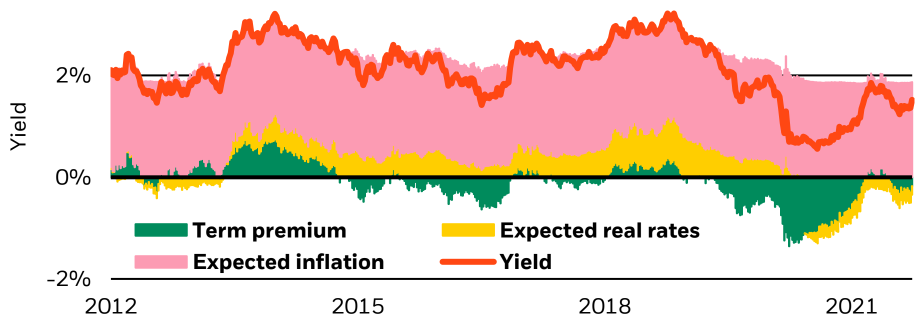
Putting the yield spike in perspective

- We view the U.S. Treasury yield spike as resolving a disconnect between the powerful restart and lower yields in recent months, and stay tactically pro-risk.
- U.S. 10-year yields jumped to the highest level in three months. Markets are prone to volatility but ultimately we see yields rising gradually.
- Investors will focus on U.S. employment data especially as it is key to the Fed's interest rate liftoff decision.

The recent jump in U.S. Treasury yields has spooked investors. Not all yield rises are the same. Yields driven up by rising policy rate expectations may harm equity valuations. We see the recent yield spike as partially correcting the disconnect between the powerful restart and falling yields that had led to an overly compressed term premium. We see this as a more benign adjustment, and view ongoing negative real yields and the broadening restart supporting risk assets.

What's driving the yield spike?

U.S. 10-year Treasury yield breakdown, 2012-2021



Past performance is no guarantee of future results. Sources: BlackRock Investment Institute, with data from Haver Analytics, September 2021. Notes: The chart shows breakdowns on the drivers of U.S. 10-year Treasury yields based on historical market pricing of expected real rates, expected inflation and the term premium. The term premium – or the amount investors expect to be compensated for lending over long periods – is based on a model similar to Andreasen et. al. https://www.frbsf.org/economic-research/files/wp2017-11.pdf (2017).

The market narrative that the spike in yields is driven by concerns about higher U.S. policy rates misses the point, in our view. We see a more compelling driver: an overdue correction of the disconnect between low yield levels and the economic restart. We had argued since the spring that yields were too low given the broadening restart and this would ultimately be corrected. Back then it took weeks for yields to rise about 20 basis points to 1.50% level, and this time it only took a week – underscoring our view that markets may be catching up to the reality of the restart. We see more drastic yield increases as unwarranted. Our analysis also shows the latest yield spike was driven by an increase in the term premium – or the compensation demanded by investors for the risk of holding longer-term government bonds. See the chart above. We believe higher term premia in this environment need not be bad news for equities, and still very negative real yields remain supportive of the asset class. Over the next six to 12 months we stay overall pro-risk even as we believe the path for further gains in risk assets has narrowed after an extended run higher and there could be bouts of volatility, including in the bond market.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Markets have been jittery after an extended run higher in risk assets. We see it particularly important to have an anchor in such a noisy market environment, such as our view that we are going through an economic restart rather than a typical business cycle recovery. U.S. growth momentum has already peaked, and this is not surprising to us given the nature of the restart. You can only turn the lights back on once, so to speak. We have also long warned against extrapolating too much from volatile near-term activity data amid unusual restart dynamics. We also firmly believe in our *new nominal* theme – Short-term yields will likely stay lower than they would have in similar past periods as central banks keep policy accommodative, and longer-term yields will gradually rise on the back of a revival of term premia and higher medium-term inflation. This is why we don't find the recent Treasury yield spike alarming; and why we uphold our pro-risk stance and stay broadly underweight government bonds, particularly for longer maturities.

Against this backdrop we expect real interest rates to stay firmly in negative territory, supporting risk assets. We are modestly overweight equities on a tactical horizon, with a preference for cyclicality and quality. This is expressed through our regional views. For example, we are overweight European equities as we expect this market to benefit more from the broadening global restart. In fixed income, we have recently shifted our tactical stance on emerging market (EM) local-currency debt to a modest overweight. We do not see the recent yield backup – or the Fed's tapering – leading to an EM tantrum given higher real yields and improved external balances in EM economies.

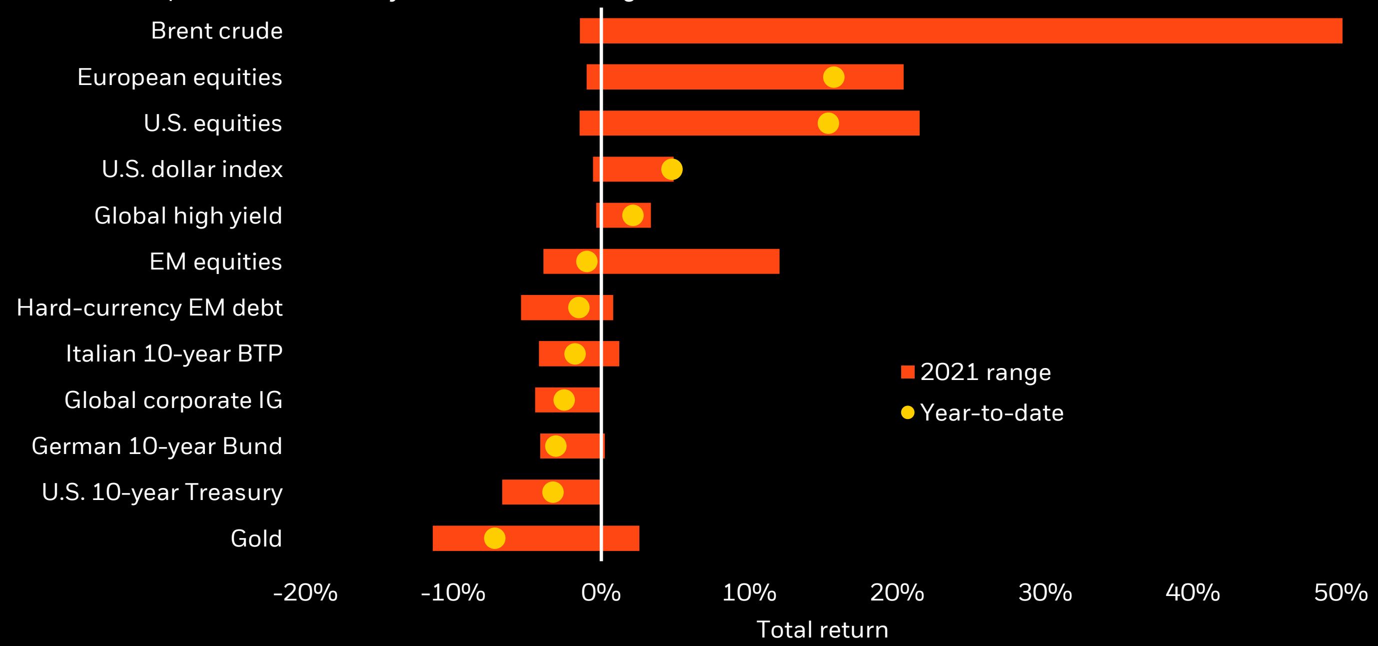
The bottom line: We view the recent U.S. Treasury yield spike as resolving a disconnect between the restart and low yield levels, and not reflecting a hawkish pivot by central banks. Our *new nominal* theme has played out this year and remains a key anchor of our views, including our expectation for longer-term yields to gradually push higher while front-end yields stay anchored. We also see the *new nominal* supporting risk assets, especially given the still robust growth backdrop. Over the next six to 12 months we stay overall pro-risk but see a narrowing path for risk assets to push higher – with the potential for bouts of volatility. 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 prefer Treasury Inflation-Protected Securities over nominal bonds for portfolio duration exposure, especially after the recent pullback. We are underweight global investment grade credit as we see little room for further yield compression. Read our detailed views in our Q4 Global outlook update.

Market backdrop

U.S. 10-year Treasury yield jumped above 1.50% for the first time in three months, fuelling the largest daily decline in the S&P 500 Index since May. We view the yield backup as correcting a disconnect between the restart and earlier yield levels, rather than foreshadowing a more drastic yield rise. The U.S. government averted a shutdown. 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 Sept. 30, 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, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, 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

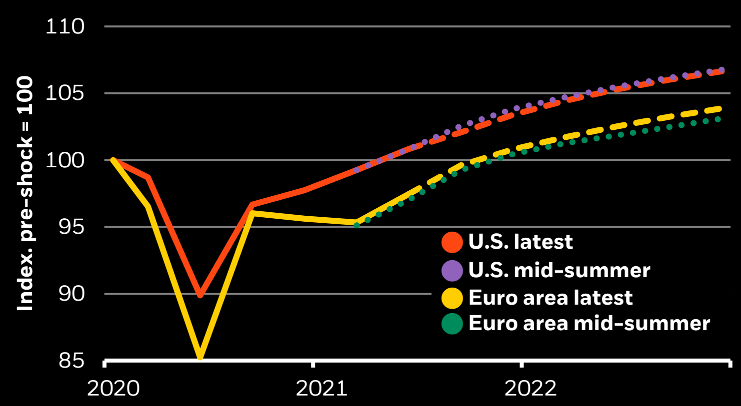
Growth momentum has slowed in the U.S. and euro area over the summer even as the absolute level of activity stays elevated. September activity surveys showed a drop in both manufacturing and services. Several factors are at play.

Rising Covid infections have weighed, especially in the U.S. Concerns about the quality and cost of labor loom large for U.S. firms – more so than in the euro area where demand concerns – particularly in the service sector – are a bigger challenge. Supply chain disruptions are being felt by both, and European manufacturers see this as their biggest problem at the moment, according to surveys.

We expect these temporary frictions to resolve and for GDP in both the U.S. and euro area to return to pre-Covid trend in 2022. See the chart. U.S. GDP is projected to be a touch lower in the near term than prior projections, yet growth in 2022 is stronger and the gap is eliminated by the end of next year. In Europe, activity projections have been downgraded in the past few weeks, but the latest expectations still remain above those from July. See our macro insights hub.

Economic activity continues recovery

U.S. and euro area real GDP vs. consensus estimates, 2020-2021



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, Eurostat, Refinitiv Eikon, Bloomberg, with data from Haver Analytics, September 2021. Note: The chart shows the historical and projected level of GDP for the U.S. and euro area. The orange dashed line shows the current median consensus expectation of the level of GDP in the U.S. and the yellow dashed line shows the equivalent in the euro area. The purple and green dotted lines show the U.S. and euro area median expectations as of late July 2021.

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. 4	U.S. factory orders
Oct. 5	Japan, U.S. services purchasing managers' index (PMI); euro area composite PMI
Oct. 6	German industrial orders
Oct. 8	U.S. nonfarm payrolls; China Caixin services PMI

Investors will closely watch U.S. labor market data given its relevance to the Fed's interest rate decision. The Fed has been reluctant to confirm its inflation objective has been met, and does not yet see the employment goal has been satisfied. Economists expect an increase of 500,000 payrolls in September, after August payrolls growth slowed sharply to 235,000.

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 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, 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 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.
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			We turn 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.
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. 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.
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 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 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 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.
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 upgrade local-currency EM debt to overweight. We believe the asset class offers attractive valuations and carry in a world starved for income.
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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