Weekly commentary

BlackRock

September 13, 2021

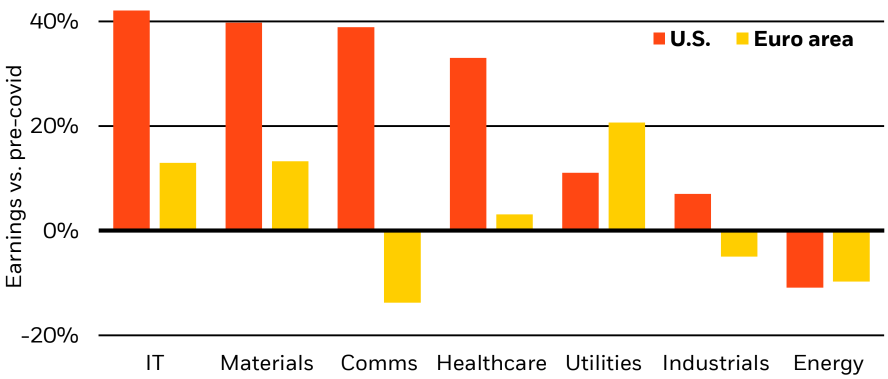
The importance of getting granular

- We still favor equities over credit and government bonds in strategic portfolios, and advocate a more granular approach to portfolio construction.
- The European Central Bank (ECB) decided to reduce the pace of asset purchases under its pandemic emergency purchase program for Q4.
- Investors will focus on U.S. consumer price index (CPI) data to assess the persistence and breadth of inflationary pressure amid the restart dynamics.

Investors are grappling with an unusually wide range of potential economic outcomes beyond the post-pandemic restart, reflected in frequent shifts in equity market leadership and volatile bond yields. We stick to the anchor of our three key investment themes – and a broad strategic preference for equities over bonds in our updated long-term return assumptions. A more granular approach could help better capture these themes and provide diversification in portfolios, in our view.

Diverging earnings prospects

Forward earnings estimates by sector vs. pre-Covid level, August 2021



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2021. Notes: The chart shows 12-month forward earnings for the selected sectors within the MSCI USA and MSCI EMU indexes relative to their pre-Covid trend. Respective MSCI sector indexes are used as proxies. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Our three investment themes are *the new nominal*, or a more muted central bank policy response to higher inflation than in the past, *China stands out* as a distinct asset class and global growth engine, and the *journey to net zero*. We advance our portfolio construction tool kit in two ways to reflect a more granular approach: One, we take explicit views across the yield curve; two, in equities we use sectors as the unit of analysis to inform our regional views. Rising earnings growth expectations and low interest rates have helped offset the impact of higher equity prices on our overall expected long-term returns. We've witnessed diverging earnings expectations across regions and sectors during the pandemic. Some sectors in the U.S., such as IT, materials and communications, have dramatically eclipsed their pre-pandemic earnings estimates. See the chart. In Europe, earnings estimates still lag pre-Covid levels in some areas but the earnings revision ratio – the ratio of the number of stocks with corporate earnings upgrades to those with downgrades – has been rising sharply, supporting our recent tactical upgrade of European equities to overweight.

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BlackRock **Investment** Institute

We believe a sectoral approach to asset allocation in equities will allow investors to better tap into structural themes that are being turbocharged by the pandemic, such as sustainability. Climate change and the green transition will likely affect all assets, but it will be most pronounced at the sector rather than broad market level, in our view. Some sectors may benefit from being aligned with the green transition, as solution providers or by being less exposed to transition risks, including tech and healthcare. Others such as energy and utilities may face longer-term challenges even if restart dynamics brighten their near-term appeal. Just to be clear: These are broad sectoral views – and some individual companies within sectors may buck these trends, creating opportunities for differentiation.

We maintain high conviction in our *new nominal* theme that implies low real yields – a positive for risk assets. The fall in long-dated yields through the second quarter – a reversal from the climb earlier in the year – has further eroded our expected long-run returns across government bonds and credit. Yet we believe the interest rate environment lends itself to more granularity because the *new nominal* is effectively all about varying views across different parts of the yield curve. We expect short-term yields to likely stay low as central banks keep policy accommodative, yet see longer-term yields gradually rising on the back of higher medium-term inflation and a revival of term premia (the compensation investors demand for holding riskier longer-term bonds). As a result we expect the yield curve to be steeper in five years than the market is currently pricing. The implication? A preference for shorter-dated nominal government bonds over longer maturities within our overall strategic underweight on the asset class.

The bottom line: We prefer equities to credit and government bonds in strategic portfolios, and see the need for a more granular approach. In fixed income, we prefer inflation-linked bonds to nominal government bonds due to our medium-term inflation expectations and the diminished diversification role of nominal bonds. The lower for longer rate environment also boosts the appeal of private markets for eligible investors, in our view. We also still see a strong strategic case for Chinese assets – especially government bonds – even after allowing for sizable uncertainties, in large part because we believe even a "neutral" strategic allocation to China is significantly higher than current index weights and modest client allocations to Chinese assets. We recognize that precise implementation of more granular views in practice can differ widely among different types of investors.

Market backdrop

The ECB decided to reduce the pace of asset purchases under its pandemic emergency purchase program (PEPP) for the fourth quarter as expected. The central bank upgraded its growth and inflation forecast for this year, but expected inflation to remain far below target over the medium term. We expects the ECB to step up its regular asset purchases when the PEPP program expires early next year to achieve its medium-term price stability goals under its new policy framework. U.S. stocks declined from record high levels and the U.S. dollar rose as uncertainties over growth prospects weighed on markets.

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. 9, 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, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), 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 U.S. 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and spot gold.

Macro insights

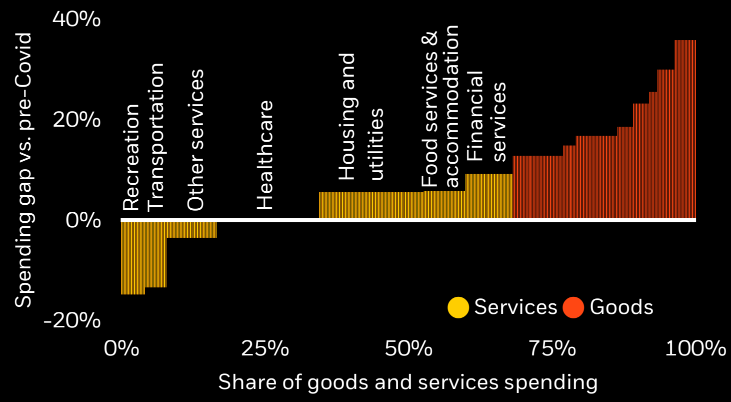
U.S. consumption is continuing to rebound, albeit at a slower pace than during the unprecedented growth in the first half of the year. We expect consumption to fully restart, even if the timing may be delayed by the virus dynamics – fueling a return of GDP to pre-Covid trend by the end of the year.

Some of the biggest gains in spending have been in contact-intense services such as transport and recreation, according to the latest U.S. personal income and outlays data. Yet there is still a sizable shortfall compared to pre-Covid levels. See the chart. That said, real services spending as a whole is now within 3% of its pre-Covid level. Together with this year's surge in goods consumption, overall spending is now over 2.5% *above* the pre-Covid high watermark.

As the labor market continues to improve, we are likely to see savings rate normalizing from high levels and consumers starting to draw on excess savings accumulated during lockdown. Both these factors will support sustained consumption growth and drive GDP to pre-Covid trend by the end of the year, in our view. See our macro insights hub.

U.S. consumption restart underway

Consumer spending vs. pre-pandemic levels, by sector



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Haver Analytics, September 2021. Notes: The bars show the level of nominal consumption spending on different categories of goods and services expressed relative to the level of spending in February 2020. A negative reading denotes spending below the Feb 2020 level and a positive reading indicates spending higher than that level. The width of bars denotes the share of that category of spending in total consumer spending. Healthcare accounts for nearly 18% of the spending and is 0.3% below pre-Covid levels.

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 reXmaining 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 14	U.S. consumer price index (CPI)	**Sept 16**	U.S. Philly Fed Business Index
Sept 15	China industrial output and retail sales; U.S. industrial production	**Sept 17**	U.S. University of Michigan Surveys of consumers

All eyes are on August U.S. CPI data – and whether the monthly pace of price increases slowed down from July. The data will help investors assess the persistence and breadth of inflationary pressure amid the unprecedented restart dynamics. We believe the path of inflation will likely be higher than market pricing implies, mostly as a result of the policy revolution in response to the Covid shock and the shift in the Fed's monetary policy framework.

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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