# Weekly commentary

BlackRock

Oct. 12, 2020

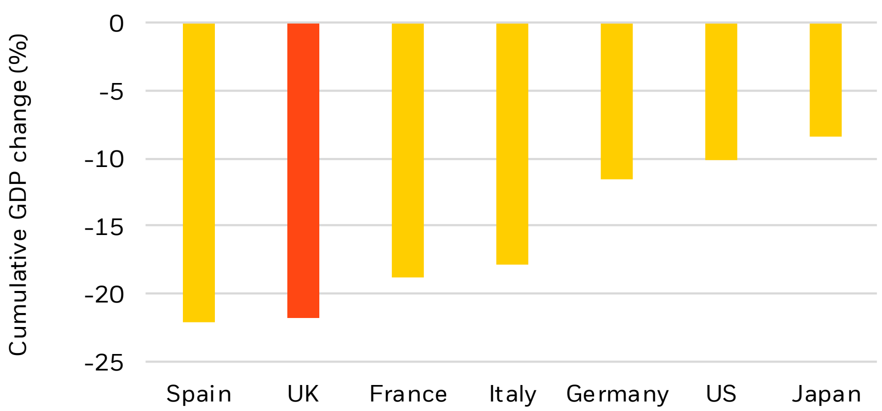
## UK: a case study in virus dynamics

- We focus on the UK to illustrate the dynamics of the three signposts we use in evaluating the virus shock: restart, policy revolution and economic scarring.
- Talks around a pre-election U.S. fiscal package continued in fits and starts - though the path to enactment of any deal appears very narrow.
- The International Monetary Fund may increase its global growth forecasts this week, from more bearish earlier predictions.

We zero in on the UK this week to highlight the three main signposts we use to assess the impact of the coronavirus: the pace of the economic restart, the state of policy support and evidence of permanent economic damage. The UK's experience confirms our assessment that the cumulative virus impact will ultimately be a fraction of that of the 2008 financial crisis, but it also shows the challenges ahead.

### Chart of the week

Cumulative hit to real GDP, Q4 2019 to Q2 2020




Sources: BlackRock Investment Institute, with data from Haver, October 2020. Notes: The chart shows the cumulative change in real GDP from the fourth quarter of 2019 through the second quarter of 2020 for each country/region.

The UK has been one of the hardest hit developed economies in the Covid-19 pandemic. GDP fell nearly 22% in the first half of 2020, a much bigger shock than other developed countries. See the chart above. Part of this reflects a relatively high concentration of services in the UK's overall economic activity. The other reason is that the UK lockdown started later but lasted longer than in other European countries as infection rates were slower to drop in the UK. That said, as we previously set out in our framework for assessing the Covid-19 macro shock, financial markets should be focused on the cumulative shortfall in GDP versus its trend, rather than the initial drop in output. On that score, consensus forecasts suggest the UK's cumulative GDP loss over coming years will be well below that seen in the wake of the global financial crisis. As in other regions, this is thanks to the timely and overwhelming initial policy response. The same holds true for Europe, and especially the U.S. – where we see the cumulative hit as smaller.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The economic restart is under way in the UK. Google data point to mobility roughly 30% below pre-pandemic levels, versus 70% at the trough. This recovery has been somewhat softer than that seen in the euro area and U.S. We believe the recent resurgence in infections – in the UK and many parts of Europe – should not be classed as a second wave, as it partly reflects materially higher testing rates than at the earlier peak of the pandemic. Our assessment also reflects a UK government that is acting preemptively now – especially after criticisms of its late introduction of the initial lockdown and despite weakening political support for reintroducing lockdowns. Future pauses or delays to the activity restart are likely to be materially less significant to the overall economy, we believe.

How about policy support? The UK saw an early policy revolution with a comprehensive and coordinated fiscal and monetary easing with the aim of bridging the gap in private sector incomes. The government's furlough program saw the state cover most of the costs of keeping workers on payrolls in affected industries. This has kept the unemployment rate low. The Bank of England unveiled a broad package of easing measures and in August added negative interest rates to its policy toolbox –but is unlikely to cut rates below zero in the near term. Weaker data could well be met with further asset purchases.

The risk? Unemployment is set to rise as the UK's furlough program winds down and is replaced by a more limited program that supports "viable" jobs and companies legally forced to close to stop the virus spread. This highlights the balancing act facing some governments, weighing the desire to provide an income bridge against the cost of impeding reallocation of resources away from nonviable firms in a post-Covid world. Fading policy support is also a key risk in the United States, where talks over additional fiscal support face a narrow and steep path ahead of the November election.

One key challenge looms that could affect the UK economy's long-term health: negotiating a post-Brexit trade deal with the EU. Tensions increased after the UK floated rules that appeared at odds with a previous agreements, but we still believe that there will ultimately be some form of "skinny" trade agreement. The potential downside for the UK is greater than Europe, which has galvanized its policy response to the crisis by starting a pan European Recovery fund. Overall, our UK assessment offers a window into how we view other regions and markets. This points to potential for a more cautious view on Europe than we currently hold – and a more optimistic one on emerging markets.

# Market backdrop

COVID infections have picked up in Europe and parts of the U.S., but fatalities are far off peaks reached in the spring. Democratic presidential nominee Joe Biden has widened his lead in polls ahead of the Nov. 3 election, but the race for the Senate looks closer. Talks over a U.S. fiscal stimulus package continued in fits and starts, but the path to a pre-election deal is narrow. This raises the risk of permanent economic scarring and a weakening of an activity restart that has been running ahead of expectations. The U.S. election could change this, as differences in fiscal impulses between the outcomes are large.

## Assets in review

Selected asset performance, 2020 year-to-date and range


**Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.** Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent 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: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

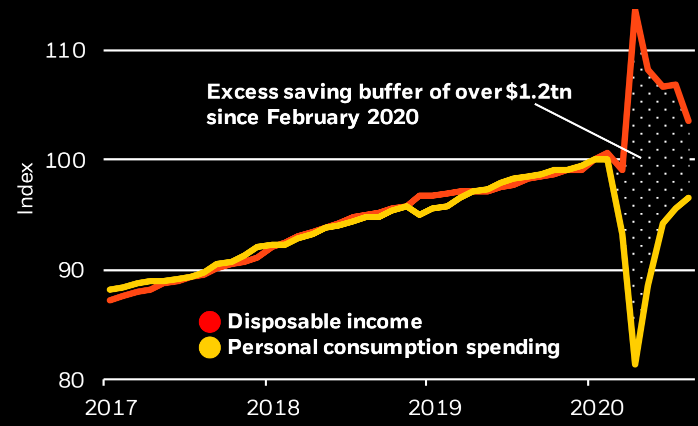
# Macro insights

Fiscal support – through beefed-up unemployment insurance and direct stimulus checks – has provided a critical bridge for U.S. household incomes through the Covid pandemic. It has helped households build up a buffer of over $1.2 trillion in excess of normal savings. See the chart. This should help sustain consumer spending – at least for now. But there are risks: Negotiations on another round of fiscal support appear to have broken down, perhaps forcing some consumers to eat into their savings. And savings are concentrated in the hands of wealthy households less likely to spend the excess.

U.S. employment data point to a continued restart in economic activity, with a further fall in the unemployment rate and a slight increase in average hourly earnings. The Covid-19 labor market shock is unlike cyclical recessions; unemployment jumped from 4.4% to 14.7% when activity shut down in April - far more than in past crises. But as activity restarted, unemployment recovered rapidly, even though the pace of improvement has slowed recently.

## Savings surge

U.S. consumer disposable income and spending, 2017-2020




Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, Oct. 2020. Note: The income (orange line) and consumption (yellow line) series are re-indexed to equal 100 in January 2020. Excess savings are defined as monthly saving in excess of average monthly saving in 2019. The $1.2 trillion buffer is the accumulation of excess saving from February-August 2020, expressed in non-annualized terms.

# Investment themes

## 1 Activity restart

- The activity restart has broadened and is still running ahead of expectations in developed markets, as reflected by the IMF's recent signaling of an upgrade to its global growth outlook. Yet the restart is moving at different speeds across countries, driven by differences in virus dynamics.
- COVID infections have picked up in Europe and parts of the U.S, but fatalities and hospitalizations have risen only moderately. This suggests the current resurgence is much smaller than the first wave when correcting for testing capacity. We see local restrictions as the main virus approach, and a return to full national lockdowns as unlikely.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-COVID world could be painful, especially for contact-intensive sectors.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield – in both strategic and tactical portfolios. We have a preference for cyclical assets in Europe.

## 2 Policy revolution

- The joint fiscal-monetary coordination in response to the COVID-19 shock is nothing short of a policy revolution. The Federal Reserve is leading major central banks in evolving policy frameworks to explicitly aim to let inflation overshoot targets – a desirable move in the current environment but the lack of proper guardrails raise concerns.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus. Negotiations on a pre-election fiscal package continue in fits and starts, but the window for a pre-election deal is rapidly narrowing. We also see a need for the European Central Bank to step up its relief programs to cushion the euro area economy.
- Europe's historic recovery fund will introduce mutualized debt and create jointly issued European bonds that can compete with other perceived safe-haven assets. It still needs approvals by the European and national parliaments.
- The blurring of monetary and fiscal policy means that it is crucial to have proper guardrails around policy coordination. In their absence we see a risk that major central banks could lose grip of inflation expectations relative to their target levels. Combined with other structural changes accelerated by COVID such as deglobalization, it could lead to a higher inflation regime in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions in technology stocks.

## 3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We believe countries, sectors and companies will make a comeback as diversifiers in a more fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. Investors should consider alternative return sources that can provide diversification, such as private markets.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer sustainable assets, private markets and deliberate country diversification for strategic portfolios. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops, and generally prefer developed markets over the emerging world.

# Week ahead

**Oct. 12–19** China total social financing, new yuan loans and money supply

**Oct. 15** Philly Fed business index

**Oct. 13** Germany ZEW economic sentiment survey

**Oct. 16** University of Michigan consumer sentiment index

Market attention will turn to key data releases gauging the status of the economic recovery across the world. In the U.S. and Europe, we'll get more color on economic sentiment, especially in areas where virus infection rates continue to pick up. The annual IMF meetings will also be in focus, with growth forecasts likely to be revised up from earlier more bearish projections.

# Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, October 2020

| Asset | Strategic view | Tactical view | |
|---|---|---|---|
| Equities | Neutral | Neutral | We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall . We like the quality factor for its resilience and favor Europe among cyclical exposures. |
| Credit | Neutral | +1 | We are neutral on credit on a strategic basis because we see investment grade (IG) spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, we strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt. |
| Govt bonds | -1 | Neutral | The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. Such low rates reduce the asset class's ability to act as ballast against equity market selloffs. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation suppresses yields. |
| Cash | | Neutral | We are neutral on cash. Holding some cash makes sense as a buffer against supply shocks that could drive both stocks and bonds lower. |
| Private markets | Neutral | | Non-traditional return streams, including private credit, have the potential to add value and diversification. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures but valuations and inherent uncertainties of some private assets keep us neutral overall. |

Note: Views are from a U.S. dollar perspective, October 2020. 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 2020

| | Asset | Underweight | Overweight | |
|---|---|---|---|---|
| Equities | United States | | | We are neutral on U.S. equities. Risks of fading fiscal stimulus and an extended epidemic are threatening to derail the market's strong run. Renewed U.S.-China tensions and a divisive election also weigh. |
| Equities | Euro area | | ■ | We are overweight European equities. The region is exposed to a cyclical upside as the economy restarts, against a backdrop of solid public health measures and a galvanizing policy response. |
| Equities | Japan | | | We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization. |
| Equities | Emerging markets | ■ | | We are underweight emerging market equities. We are concerned about the pandemic's spread and see less room or willingness for policy measures to cushion the impact in many – but not all – countries. |
| Equities | Asia ex-Japan | | | We hold Asia ex-Japan equities at neutral. Renewed U.S.-China tension is a risk. China's goal to balance growth with financial stability has led to relatively muted policy measures to cushion the virus fallout. |
| Equities | Momentum | | | We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold. |
| Equities | Value | | | We are neutral on value. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance. |
| Equities | Minimum volatility | | | We hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures. |
| Equities | Quality | | ■ ■ | We keep our strong overweight on quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy. |
| Fixed Income | U.S. Treasuries | | ■ | We still like U.S. Treasuries. Long-term yields are likely to fall further than other developed market peers, even as low rates reduce their ability to cushion against risk asset selloffs. |
| Fixed Income | Treasury Inflation-Protected Securities | | | We are neutral on TIPS. A huge decline in rates makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations. |
| Fixed Income | German bunds | ■ | | We remain underweight bunds as current yield levels provide little cushion against major risk events. Also, potential issuance related to the proposed EU recovery fund could compete with bunds for investment. |
| Fixed Income | Euro area peripherals | | ■ | We are overweight euro area peripheral government bonds despite recent outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions. |
| Fixed Income | Global investment grade | | | We hold investment grade credit at neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive. |
| Fixed Income | Global high yield | | ■ ■ | We keep our strong overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world. |
| Fixed Income | Emerging market – hard currency | ■ | | We are underweight hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced. |
| Fixed Income | Emerging market – local currency | ■ | | We are still underweight local-currency EM debt. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic. |
| Fixed Income | Asia fixed income | | | We are neutral on Asia fixed income. The pandemic's containment in many countries and low energy exposure are positives. Renewed U.S.-China tensions and China's relatively muted policy fallout are risks. |

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