Weekly commentary

BlackRock

Nov. 9, 2020

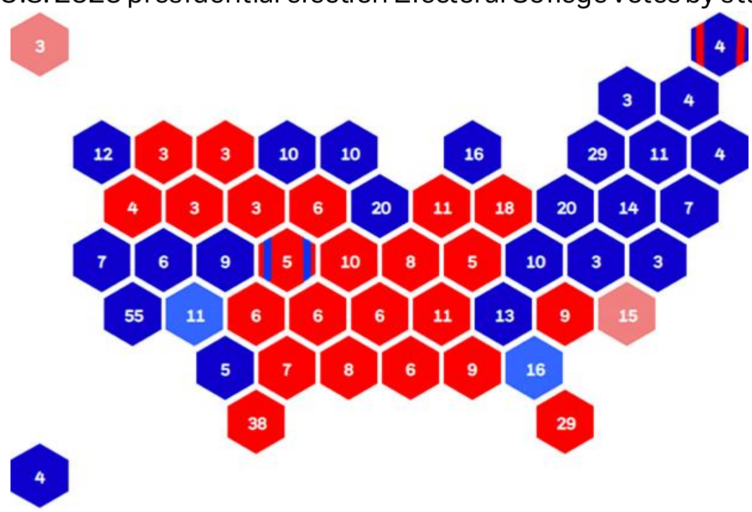
Investing after the U.S. election

- A Democratic victory without Senate control is for now reinforcing existing market trends such as the hunt for yield and growth stocks.
- A resurgence of Covid-19 cases has led to new national lockdowns in Europe, threatening to weigh on mobility and activity in the near term.
- Data from the euro area and U.S. could shed light on the impact of the virus resurgence and new lockdown measures on the economic restart.

Joe Biden's victory in the presidential race likely ushers in a near-term market environment dominated by low rates, a hunt for yield and growth stocks. A Democratic takeover of the Senate looks unlikely, which would constrain the Biden administration's ability to implement large-scale fiscal stimulus and public investment, tax, healthcare and climate related legislation.

Chart of the week

U.S. 2020 presidential election Electoral College votes by state



Sources: BlackRock Investment Institute, with data from the Associated Press (AP) and New York Times as of Nov. 8, 2020. Notes The map shows the projected winner of the U.S. presidential election in each state, as well as the states' Electoral College votes. Solid blue and red hexagons represent the states where a winner has been called. Pale blue and pale red hexagons represent states where the results have not been called. Blue represents Biden and red represents Trump.

President-elect Biden flipped the key states of Michigan, Wisconsin and Pennsylvania, giving him more than the needed 270 electoral votes to win the White House. See the chart above. We see the likelihood that recounts and legal challenges could overturn this outcome as remote and favor looking through any resulting market volatility. Democrats' effort to take control of the Senate has met roadblocks. Two Senate seats in Georgia are headed for a January runoff election, giving Democrats a narrow path to winning both and yielding a 50-50 Senate, with the vice president as the tie breaker. A divided government – with Republicans retaining their control of the Senate – could see greater regulation for many sectors, but big-ticket legislative actions including large-scale fiscal stimulus and public investment, tax, healthcare and climate related legislation would likely face insurmountable hurdles.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Fiscal policy is critical for preventing permanent economic damage from the virus shock. Some fiscal relief looks possible in the near term during the lame-duck session of Congress, but we see the scope and size of fiscal stimulus and public investment as much more modest than what a united Democratic government might deliver. We're monitoring the fiscal response closely, as a premature retrenchment could set back an economic restart that has so far surprised to the upside. Taxation policies would likely stay steady under a Republican Senate. Long-term U.S. Treasury yields had run up ahead of Election Day in anticipation of a Democratic sweep, bringing forward a rise in yields we expect to see in a higher inflation regime in the medium term. The prospect of a divided government removed the accelerant and brought yields down for now. Yet we still expect yields to slowly move up over the next few years, boding well for risk assets, especially for credit and growth companies that have dominated markets for much of the post-crisis period.

A Biden win likely signifies a return to more predictable trade and foreign policy. We believe emerging market (EM) assets should perform on improved trade sentiment, especially in Asia ex-Japan. In addition, many Asian countries have managed to contain the virus and are ahead in the economic restart. Yet we see U.S.-China rivalry staying structurally elevated across technology, trade and investment, due to bipartisan support for a more competitive stance on China. We also see an increased focus on sustainability under a divided government through regulatory actions, rather than via tax policy or spending on green infrastructure, and a rejoining of the Paris Agreement to combat climate change.

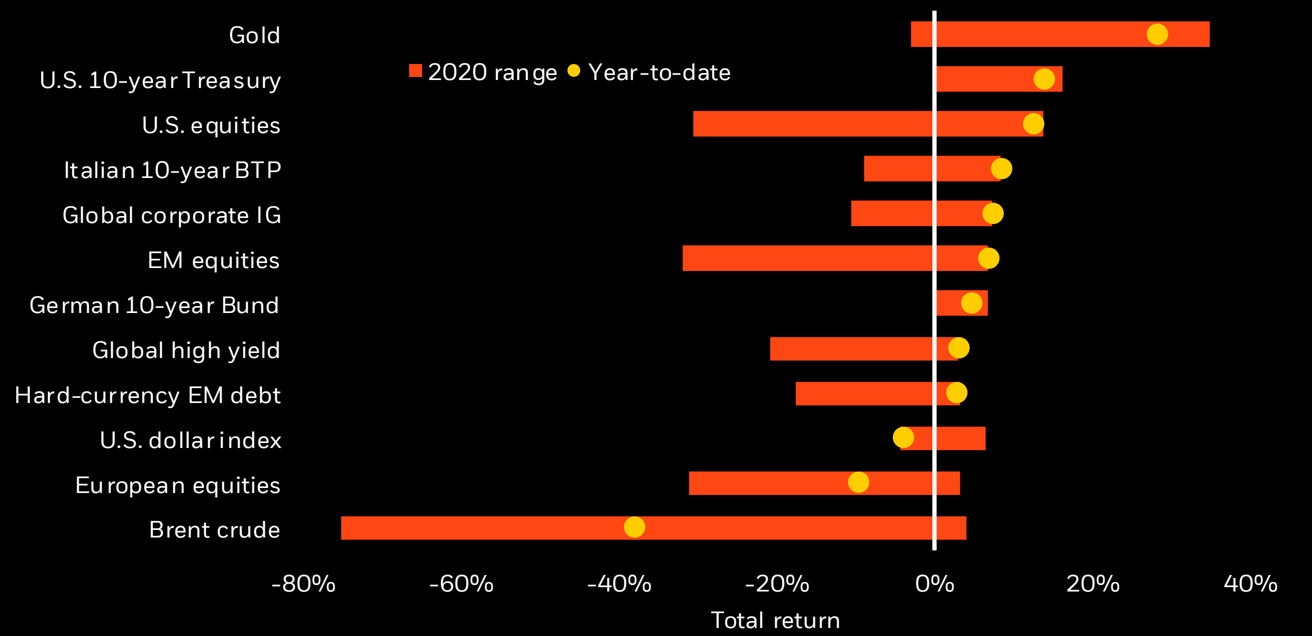
The bottom line: A Biden divided government would bring significant changes in foreign policy and regulation – both in substance and tone. Yet the legislative agenda would be constrained, taking off the table the more transformative scenarios being contemplated ahead of the election. The likely implication: continuity in the market environment. We expect the quality style factor and large-cap equities to perform strongly – as they have often done in the past. Large-cap tech stocks have led the post-election rally, yet we note they would face regulatory pressure even under a divided government. We are reviewing our tactical asset views in light of the election result. Other key inputs include the evolution of the virus shock and the timeline for a vaccine – and their potential to bring forward market expectations of inflation and change equity market leadership to cyclicals.

Market backdrop

A resurgence in Covid infections has led a number of European countries to re-impose national lockdowns, though they are less stringent than seen during the initial outbreak. We see the virus resurgence and new government restrictions temporarily disrupting the economic restart that had been stronger than expected. The U.S. election outcome and potentially a smaller-than-expected fiscal package raise the question on the extent of permanent scarring of the economy.

Assets in review

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



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2020. 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: spot gold, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

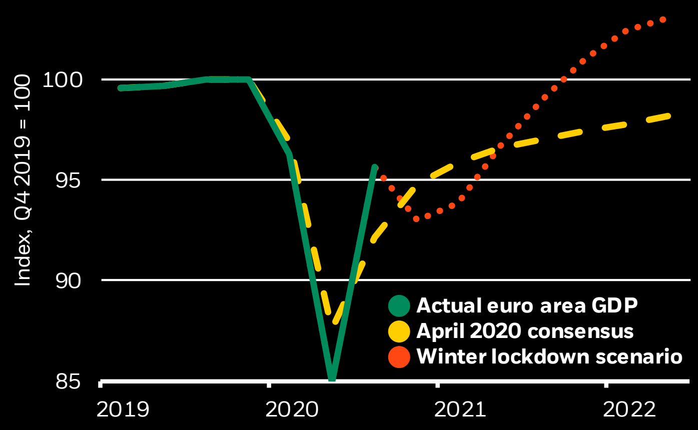
Macro insights

New lockdown measures in Europe are likely to cause activity to contract in the fourth quarter, in our view. Yet we see economies still on track to return to pre-Covid trends if policy support remains robust. We believe Investors should look through the near-term stop-start cycle and focus on the eventual cumulative loss in GDP – still projected to be a fraction of that seen after the Global Financial Crisis.

Recent GDP data show the restart had been running ahead of expectations. See the green and yellow lines in the chart. We project a path for euro area GDP using empirical work by the IMF and our estimate of lockdown stringency. The restart may be disrupted in the near term, yet growth is expected to pick up to a level well above April consensus forecasts. See the dotted orange line. If fiscal policy can provide an income bridge – as it did earlier in the year – then permanent economic scarring could be limited. The activity restart should accelerate again once restrictions are lifted and as a vaccine becomes widely available.

Gauging growth

Actual euro area GDP and growth estimates, 2019-2022



Sources: BlackRock Investment Institute, Eurostat, IMF and Refinitiv, with data from Haver Analytics, Nov. 2020. Notes: The green line shows the actual euro area GDP. The yellow line is the consensus forecast from April 2020. The orange line is our growth projection based on empirical work by the IMF and our estimate of euro area lockdown stringency based on announced measures. GDP is plotted as an index rebased to 100 in Q4 2019. There is no guarantee any forecasts made will come to pass.

Investment themes

1 Activity restart

- The activity restart is moving into a more difficult phase just as a flare-up of coronavirus infections prompts tighter restrictions. The initial phase of the economic restart has been quicker than expected, as reflected by the IMF's recent upgrade to its global growth outlook. We see the hardest part lying ahead.
- The sharp rise in Covid hospitalization rates in Europe has led to the re-imposition of national lockdowns – albeit not as stringent as in the spring. The next few weeks will be key in containing the virus – and in determining if more restrictions will be needed.
- 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 if mobility is curtailed for an extended period of time.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both a strategic and tactical horizon. We are tactically overweight broad EM, Asia ex-Japan equities and the size style factor in the U.S., and have closed our overweight in European equities.

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. Yet the recent surge in Covid cases is driving up the need for further policy support.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus, as a Biden administration could be constrained in implementing its key policy plans including large fiscal spending. The European Central Bank has committed to take new action in its December policy meeting.
- 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 both strategic and tactical horizons. 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 see countries, sectors and companies making a comeback as potential diversifiers in a fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. We believe investors should consider alternative return sources that can provide potential diversification.
- A focus on sustainability makes portfolios more resilient, in our view. We believe the adoption of sustainable investing is a tectonic shift carrying 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 on a strategic basis. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops.

Week ahead

Nov. 10–17 China total financing, new loans

Nov. 13 University of Michigan Surveys of Consumers; Q3 Flash estimate GDP for the euro area

Nov. 10 Germany's ZEW Indicator of Economic Sentiment

A number of economic indicators from the U.S. and euro area will be in focus. Markets are watching for signs that a Covid resurgence – and new lockdown measures in Europe – could put pressure on the activity restart.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 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 EM especially Asia ex-Japan stocks.
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, in our view, 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, November 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, November 2020

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. Risk of fading fiscal stimulus and an extended epidemic weigh on markets. Renewed U.S.-China tensions and a divisive election also weigh.
Equities	Euro area			We are neutral on European equities. Covid cases have surged just as the economic restart appears to be losing steam. Renewed restrictions are weighing on activity.
Equities	Japan	■		We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration.
Equities	Emerging markets		■	We are overweight broad EM equities as more stable foreign and trade policy under a Biden administration could benefit EM assets.
Equities	Asia ex-Japan		■	We are overweight Asia ex-Japan equities. China and a number of other Asian countries have done a better job of containing the virus – and are further ahead on the road to economic recovery.
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 are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
Equities	Quality		■	We are overweight quality as we see it. We see it as resilient against a range of outcomes in the pandemic and economy.
Equities	Size		■	We are overweight size. We expect small- and mid-cap U.S. companies to likely benefit from a cyclical upswing over the next 6-12 months with positive Covid vaccine development, even as the outlook for large fiscal stimulus dims.
Fixed Income	U.S. Treasuries	■		We downgrade U.S. Treasuries to underweight. The potential for fiscal spending – particularly in a Democratic sweep election outcome – could spur higher yields and a steeper yield curve.
Fixed Income	Treasury Inflation-Protected Securities		■	We upgrade TIPS to overweight. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy, greater fiscal stimulus and increasing production costs.
Fixed Income	German bunds			We upgrade bunds to neutral. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
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. 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 overweight Asia fixed income. China and other Asian countries have done better in containing the virus and are further ahead on economic recovery.

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