Weekly commentary

November 8, 2021

BlackRock

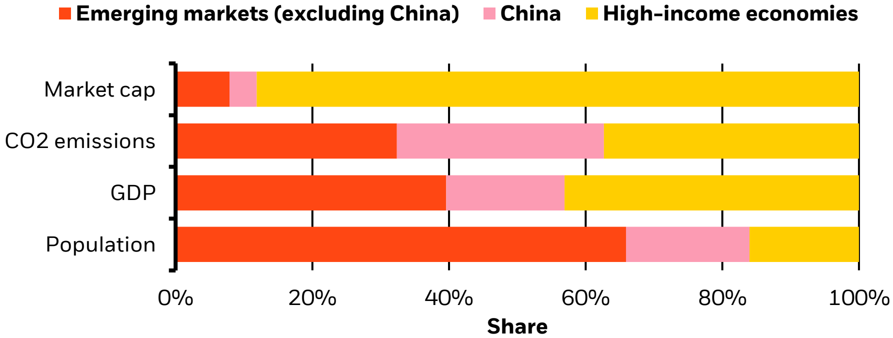
EM climate matters to global returns

- Climate risk is investment risk. The global net-zero transition will help shape portfolio outcomes over coming years, with emerging markets playing a key role.
- The Federal Reserve plans to start tapering its bond purchases in November and said the current high inflation will unlikely require a fast rise in rates.
- Data from China will be in focus. We see easing in monetary, fiscal and regulatory policies after a broad tightening has softened growth momentum.

Climate change and the transition to a low-carbon future will be a key driver of long-term asset returns. Our capital market assumptions (CMAs) are based on an orderly transition aligned with Paris Agreement goals. We've seen encouraging development from the ongoing UN climate summit (COP26). There are risks to that path. In particular, a successful transition in EMs is key for achieving the global climate goals – and for portfolio outcomes over coming years.

Mismatched resources

Distribution of resources and assets in EMs and high-income economies



Sources: BlackRock Investment Institute, IMF, World Bank, MSCI, using data from Haver Analytics and Refinitiv DataStream, October 2021. Note: The chart shows the shares in different concepts of EMs (excluding China), China and high-income economies (i.e. rest of the world). EMs are those classified as low and middle-income countries by the World Bank. For market cap, this is the share of each group/country in total world stock market capitalization measured by the MSCI world stock market capitalization, as of 4 October 2021. For CO_2 emissions, this is the share of each group/country in total world CO_2 emissions in 2018 (latest data point). For GDP this is the share of each group/country in world GDP measured using Purchasing Power Parity exchange rates, as of 2019 (before the Covid shock). For population this is the share of each group/country in world population in 2020.

All the climate pledges announced at COP26, if met in full and on time, would be enough to limit the rise in global temperatures to 1.8 degrees Celsius by 2100, according to the International Energy Agency (IEA). This is an improvement from a 2.1 degrees increase in the agency's analysis just last month. But it is still far off the goal of net-zero emissions by 2050 to limit warming to 1.5 degrees, and many pledges remain to be implemented. Implemented policy still points toward a 2.6 degrees rise. This will be particularly challenging for EMs outside China, which account for more than a third of global emissions even though they only make up a small share of the investment universe. See the chart above. We estimate EMs will need at least US$1 trillion per year in order for the world to achieve net-zero emissions by 2050 – more than six times current investment, as detailed in our recent publication *The big emerging question*. We exclude China from our estimate – given its greater capacity to finance its own journey to net zero and contribute to the global effort.

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Yet so far public funding – in the form of grants or grant-equivalent finance – has been insufficient in mobilizing private capital at scale, while the high-risk nature of EMs is a major barrier for private capital. The only way to mobilize private capital at the scale and pace needed, in our view, is for governments that have the capacity to provide support to absorb some of the potential losses on EM investments. If EM climate funding needs are not met, global temperature rises could exceed those in our base case scenario for our CMAs. Greater physical risks would lower global growth and reduce returns broadly. In general we assess the economic costs of unchecked climate change far outweigh those of transitioning to net-zero emissions. We estimate a cumulative loss in global output of nearly 25% in the next two decades if no action is taken to mitigate climate change, compared with an orderly transition scenario.

EMs are typically more vulnerable to climate-related physical damages, and their growth outlook and asset returns in turn could suffer more. Such a scenario would likely increase our strategic preference for DM equities. Our CMAs already favor DM equities in part because sectors that are likely to benefit from the green transition – such as tech and healthcare – account for a larger share of DM indexes, while carbon-intensive sectors such as energy and utilities occupy a smaller share. Yet a flood of capital flows into EMs – in addition to the necessary funding and investment – could potentially improve the outlook for EM assets on a strategic horizon. Development of new industries and transition of existing companies could make EM equities more resilient to the transition to a lower-carbon world, and allow the asset class to better seize opportunities in the transition. This dynamic isn't captured in our current assumptions.

Tactically we are neutral EM ex-China equities due to less policy support and a greater risk of scarring in these economies. In addition valuations as measured by the equity risk premium appear not as attractive relative to history. We are moderately overweight EM local-currency debt given its attractive income potential and historically cheap currency valuations.

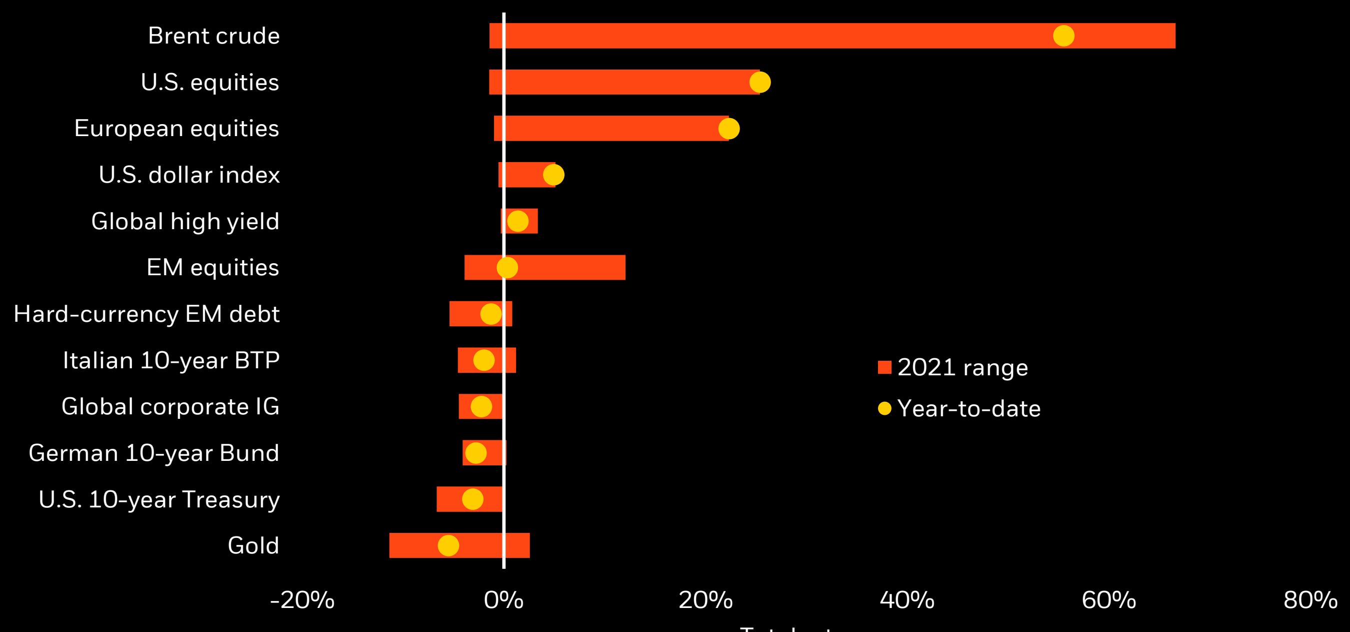
The bottom line: Climate change and the net-zero transition are key to investment outcomes over the long term. Our base case is an orderly transition – and a successful transition in EMs is key to that, in our view. We believe the only way to mobilize private capital at the scale and speed needed to fund climate actions in EMs is through risk-burden sharing and greater public sector exposures to loss, with potential tools including green investment banks.

Market backdrop

The Fed said it will start tapering its bond buying in November but shied away from pushing back against market pricing of higher policy interest rates soon after it plans to end those purchases. We think the broader market pricing of higher policy rates is overdone –both in how soon key developed market central banks may lift rates and how quickly they will do so. We've seen a partial reversal this week, especially after the Bank of England refrained from lifting rates from near zero as had been expected. U.S. payrolls grew more than expected in October, boosted by an accelerating restart in the service sector.

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 Nov. 4, 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), 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.

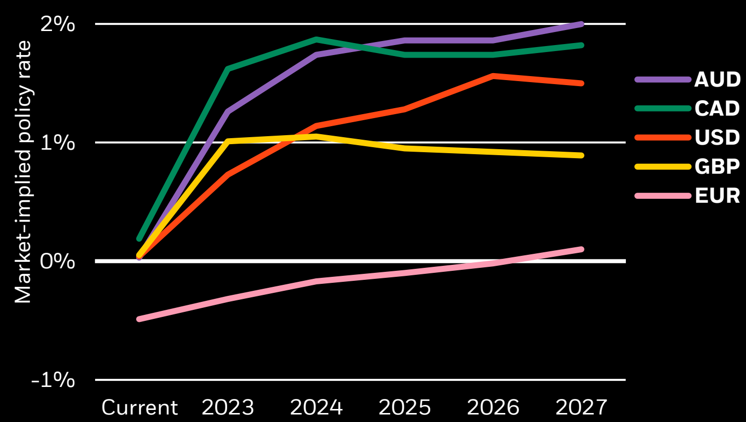
Macro insights

Recent central bank meetings show policymakers are having difficulty clarifying some of the confusion around their response to the powerful economic restart. We have argued restart dynamics are distinct from a typical business cycle recovery – and supply/demand mismatches would lead to higher inflation.

We see major central banks in roughly two groups: those that want to look through restart-driven inflation and are explicitly more tolerant of inflation – the Fed and ECB due to new policy frameworks – and those that are worried about their control over inflation expectations. Markets see the latter group following a steeper path of policy rate increases to lean against inflation, with the potential for a policy reversal soon after – see the UK in the chart. What ultimately matters is not the timing of lift-off on policy rates but the cumulative response. Whether deliberate or through an expected reversal of early policy tightening, this policy response is set to be one of the most muted in recent decades – the crux of our *new nominal* theme. See our macro insights hub.

Pricing in different lift-offs

Market pricing of central bank policy rates, 2021-2026



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, 3 Nov. 2021. Notes: The chart shows the pricing of expected central bank policy rates via forward overnight index swaps. For example, the 2023 pricing shows where the one-year forward is expected a year from now.

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 potentially lifting policy rates in late 2022 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 said it will start tapering bond purchases this month, trimming them by $15 billion a month. 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

Nov. 7-10	China total social financing, new yuan loans	**Nov. 11**	UK Q3 GDP
Nov. 10	China consumer price index (CPI), producer price index; U.S. CPI	**Nov. 12**	University of Michigan Surveys of Consumers

Data from China will be in focus. We expect near-term easing on monetary, fiscal and regulatory policies, after a broad policy tightening has led to a drop in growth momentum in China this year. We expect easier policy to bolster growth – supporting our tactical moderate overweight on Chinese equities.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 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, October 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, November 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 are 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 are 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 are modestly overweight local-currency EM debt. 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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