Weekly commentary Dec. 14, 2020

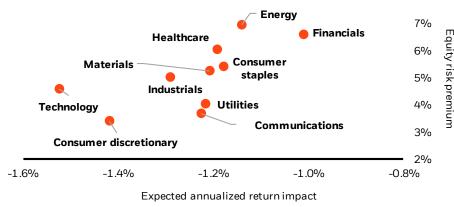
Positioning for the new nominal

- We favor inflation-linked bonds and see equities supported in strategic portfolios, expecting firmer inflation and falling real rates in coming years.
- Global stocks hit record highs amid positive vaccine news even as near-term challenges weighed. U.S. fiscal package talks continued.
- The Federal Reserve may provide some forward guidance on asset purchases at this week's monetary policy meeting.

A key consequence of this year's policy revolution is the potential for a more muted response of nominal yields to higher inflation, in our view. This means investors should start positioning their long-term portfolios for this new dynamic now, in our view. We favor holding more inflation linked bonds and see equities supported by falling real rates in strategic portfolios.

Chart of the week

U.S. sector return sensitivity to rising nominal rates, December 2020





The joint fiscal and monetary policy revolution this year implies central banks will likely keep nominal bond yields capped – even as inflation rises. We believe this has big implications for overall asset class returns – and sector performance. The sensitivity of different equity market sectors to rising interest rates varies. Traditional "value" sectors with higher equity risk premia, such as energy, typically have outperformed others in periods of rising nominal rates. The chart above shows our estimate of the expected return impact on each sector from a hypothetical 0.5% rise in U.S. nominal rates: financials and energy would suffer least and technology the most. Higher-valued growth sectors with lower equity risk premia – such as tech – have higher sensitivity to interest rates due to their long-duration cash flows. Yet rangebound nominal rates and lower real rates – as in our base case – mean we are unlikely to see a clear catalyst for a durable rotation to value from growth as past periods with rising inflation would suggest.



Jean Boivin Head – BlackRock Investment Institute

BlackRock.







Vivek Paul

Mike Pyle

Senior Portfolio Strategist – BlackRock Investment Institute



Natalie Gill

Portfolio Strategist – BlackRock Investment Institute

Visit <u>BlackRock Investment</u> <u>Institute</u> for insights on global economy, markets and geopolitics.

BlackRock Investment Institute

FOR PUBLIC DISTRIBUTION IN THE U.S., HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

The changing relationship between inflation and interest rates is a key investment theme that we name *The new nominal*, as detailed in our <u>2021 global outlook</u>. Our inflation outlook is structural in nature. It is due to the impact of the joint fiscal-monetary policy revolution and higher production costs from the expected realignment of global supply chains, rather than simply a large, external supply shock that has historically been a driver of inflationary pressures.

We do not see inflation expectations becoming unanchored as they did in the 1970s, and instead expect U.S. consumer price index (CPI) inflation to average just under 3% between 2025-2030. Yet investors may be under-appreciating the potential for higher inflation, in our view. Breakeven inflation rates – a market-based measure of inflation expectations – have risen since March, but are still materially below our expectations. Even the modest rise in price pressures we anticipate would be a significant departure from the experience of recent decades, during which inflation has persistently undershot central bank targets. This large gap between our expectation and market pricing may offer a strategic investment opportunity. Investors could start positioning their strategic portfolios to guard against risks – and take advantage of opportunities – presented by the new nominal.

In our new inflation playbook, nominal yields will be less responsive to rising inflation. Combined with the fact they are closer to effective lower bounds, we believe this likely means a narrower expected range for yields. As a result we see less negative correlations with risk assets and a challenge to the role of nominal government bonds as portfolio ballast. Falling real yields alongside higher inflation increases the expected returns of inflation-linked bonds relative to nominal government bonds, underscoring our preference to reduce nominal bond holdings and add inflation-linked exposures.

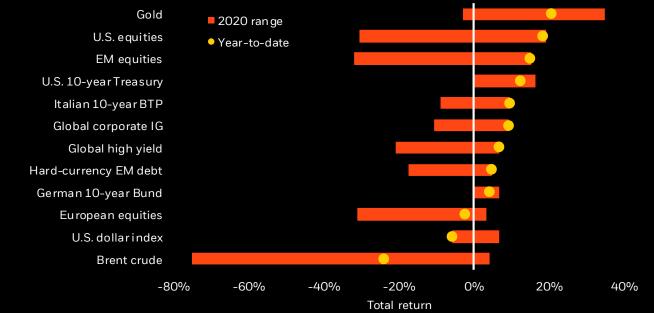
The bottom line: A new inflation regime has major implications for strategic asset allocation decisions, in our view, with a material cost to both getting the inflation call wrong and misinterpreting the impact of inflation on nominal and real yields. In our base case we prefer holding more inflation-linked bonds and less nominal government bonds. Limits on nominal bond yields mean our preferred equity allocation stays higher than it would typically in an inflationary environment. Professional investors can read more about the <u>strategic implications of the new nominal</u> in our Portfolio perspectives publication.

Market backdrop

Global stocks hit record highs as the UK started its vaccination campaign, while U.S. fiscal package talks continued. Positive vaccine news has been a game changer for markets. We now know we are building a bridge to somewhere, providing clarity for policymakers, households and companies about getting to a post-Covid stage. Yet disappointing jobs data in recent weeks pointed to near-term risks as the virus surges around the U.S., potentially slowing the restart.

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, December 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.

FOR PUBLIC DISTRIBUTION IN THE U.S., HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

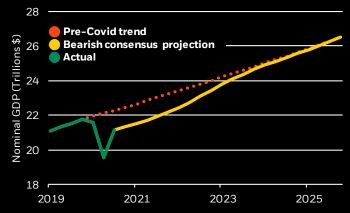
Macroinsights

Global activity should return to its pre-Covid level next year – sooner than expected at the end of the first quarter, we believe. We view the Covid shock as similar to a natural disaster, to be followed by a quick rebound. News of effective vaccines shows it is possible to build a bridge to a post-pandemic world. Better anchoring of expectations and appropriate policy support should help limit economic scarring. If this happens – despite accelerated structural change – the global economy should be able to avoid a decade-long deleveraging cycle with declining trend growth as we saw after the global financial crisis, in our view.

U.S. activity could return to its pre-Covid peak before the end of 2021, in our view. Getting back to the pre-Covid trend – key to limiting the cumulative loss in GDP to a fraction of the GFC – will likely take longer. See the chart. The most bearish consensus forecasts show it will likely take until the end of 2025 for nominal GDP to reach its pre-Covid trend. Yet the discrepancy with the pre-Covid trend may become negligible by as soon as late 2023.

The long return to trend

U.S. nominal GDP and projection, 2019-2025



Sources: BlackRock Investment Institute and Reuters, with data from Haver Analytics, December 2020. Notes: The green line shows actual nominal U.S. GDP in trillions of dollars. The yellow line shows the most bearish of the latest consensus GDP forecasts compiled by Reuters. The dotted orange line shows the pre-Covid growth trend. There is no guarantee that any forecasts made will come to pass.

Investment themes

1 The new nominal

- We see stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields even as inflation expectations climb. Inflation will have different implications to the past.
- The policy revolution as a response to the Covid shock implies that nominal yields will be less responsive to rising inflation risk than in past episodes. This suggests risk assets will perform better than in past inflationary periods.
- Medium-term inflation risks look underappreciated. Production costs are set to rise on a rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past inflation undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- Market implication: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by falling real rates. Tactically we are pro-risk, preferring U.S. equities and high yield credit.

2 Globalization rewired

- The pandemic has accelerated geopolitical transformations such as a bipolar U.S.-China world order, and a rewiring of global supply chains for greater resilience with less emphasis on efficiency.
- Strategic U.S.-China rivalry looks here to stay, with competition and bifurcation in the tech sector at its core. We believe investors need exposure to both poles of global growth.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a clear case for greater exposure to China-exposed assets for returns and diversification, in our view.
- We expect persistent inflows to Asian assets as many global investors remain underinvested and China's weight in
 global indexes grows. Risks to China-exposed assets include China's high debt levels, yuan depreciation and U.S.China conflicts. But we believe investors are well compensated for these.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like EM equities, especially Asia ex-Japan, and are underweight Europe and Japan.

3 Turbocharged transformations

- The pandemic has added fuel to pre-existing structural trends such as an increased focus on sustainability, rising inequality within and across nations, and the dominance of e-commerce at the expense of traditional retail.
- The pandemic has focused attention on underappreciated sustainability-related factors and supply chain resilience.
- It has also accelerated "winner takes all" dynamics that have led to the outperformance of a handful of tech giants in recent years. Yet we see tech exposures as having long-term structural tailwinds despite their increased valuations.
- The pandemic has heightened the focus on inequalities within and across countries due to the varying quality of public health infrastructure particularly across EMs and access to healthcare.
- **Market implication**: Strategically we prefer sustainable assets amid a growing societal preference for sustainability. Tactically we take a barbell approach, favoring quality stocks balanced with selected cyclical exposures.

Week ahead

Dec. 15 U.S. industrial production Dec. 17 Bank of England rate decision; U.S. Philly Fed business index

Dec. 16

The Fed's policy meeting; flash composite

PMI for Japan, the U.S. and euro area

Dec. 18

Bank of Japan rate decision

Monetary policy meetings of a few major central banks are the focus this week – against the background of stalling activity restart as restriction have tightened with worsening virus spread. The Fed could update guidance on its asset purchase program - such as committing to buying assets until it sees macro conditions improve – even though it is not expected to change its guidance on policy rates.

Directional views

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

		Testiselsion	Change in view	
Asset	Strategic view	Tactical view	Previous New	
Equities	Neutral	+1	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We tilt toward EM equities. Tactically, we have upgraded equities to overweight as we expect the restart to re-accelerate and rates to stay low. We like a barbell approach: quality stocks balanced with selected 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 see the economic restart and ongoing policy support helping credit perform, even amid tighter yield spreads and the wind-down of some emergency credit support.	
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 policy accommodation suppresses yields.	
Cash		Neutral	We are neutral and use cash to fund overweights in equities and credit. Holding some cash makes sense, in our view, as a buffer against the risk of 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. 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 not suitable for all investors.	

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

FOR PUBLIC DISTRIBUTION IN THE U.S., HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

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, December 2020

C int	Asset	Underweight	Overweight	
Equities	United States		→	We have upgraded U.S. equities to overweight. We see the tech and healthcare sectors offering exposure to structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
	Euro area	+		We have downgraded European equities to underweight. The market has relatively high exposure to financials pressured by low rates. It also faces structural growth challenges, even given potential for catch-up growth in a vaccine-led revival.
	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
	Emerging markets			We are overweight EM equities. We see them as principal beneficiaries of a vaccine-led global economic upswing in 2021. Other positives: our expectation of a flat to weaker US. dollar and more stable trade policy under a Biden ad ministration.
	Asia ex-Japan			We are overweight Asia ex-Japan equities. Many Asian countries have effectively contained the virus – and are further ahead in the economic restart. We see the region's tech orientation allowing it to benefit from structural growth trends.
	Momentum			We keep momentum at neutral. The factor could face challenges in the near term as a resurgence in Covid-19 cases and risks of fading fiscal policy support create potential for choppy markets.
	Value			We are neutral on value. The factor could benefit from an accelerated restart, but we believe that many of the cheapest companies – across a range of sectors – face structural challenges that have been exacerbated by the pandemic.
	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.
	Quality			We are overweight quality. We like tech companies with structural tailwinds and see companies with strong balance sheets and cash flows as resilient against a range of outcomes in the pandemic and economy.
	Size			We are overweight the U.S. size factor. We see small- and mid-cap U.S. companies as a key place where exposure to cyclicality is likely to be rewarded amid a vaccine-led recovery.
	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields as staying rangebound,but real yields declining amid rising inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
	Treasury Inflation- Protected Securities			We are overweight TIPS. We see potential for higher inflation expectations to get increasingly priced in on the back of structurally accommodative monetary policy and increasing production costs.
	German bunds			We are neutral on bunds. 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.
	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.
	Global investment grade	+		We have downgraded investment grade credit to underweight. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
	Global high yield		+ •	We have trimmed our overweight in global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency	••		We have upgraded hard-currency EM debt to neutral. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency	••		We have upgraded local-currency EM debt to neutral. We see catch-up potential as the asset class has lagged the risk asset recovery. Easy global monetary policy and a stable-to-weaker U.S. dollar should also underpin EM.
	Asia fixed income			We are overweight Asia fixed income. We see the asset class as attractively valued. Asian countries have done better in containing the virus and are further ahead in the economic restart.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

FOR PUBLIC DISTRIBUTION IN THE US., HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

BlackRock Investment Institute

The <u>BlackRock Investment Institute</u> (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. The opinions expressed are as of Dec. 14, 2020, and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks. Asset allocation and diversification does not guarantee investment returns and does not eliminate the risk of loss.

In the U.S. and Canada, this material is intended for public distribution. In EMEA Until 31 December 2020, issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL Tel: + 44 (0)20 7743 3000. Registered in England and Wales No. 2020394, has issued this document for access by Professional Clients only and no other person should rely upon the information contained within it. For your protection telephone calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock. From 31 December 2020, in the event the United Kingdom and the European Union do not enterinto an arrangement which permits United Kingdom firms to offer and provide financial services into the European Union, the issuer of this material is:(i) BlackRock Investment Management (UK) Limited for all outside of the European Union; and (ii) BlackRock (Netherlands) B.V. for in the European Union, BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 - 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded. In Switzerland, this document is marketing material. This document shall be exclusively made available to, and directed at, qualified investors as defined in the Swiss Collective Investment Schemes Actof 23 June 2006, as amended. For investors in Israel: BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. In South Africa, please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. In the DIFC this material can be distributed in and from the Dubai International Financial Centre(DIFC) by BlackRock Advisors (UK) Limited – Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it In the Kingdom of Saudi Arabia this information is only directed to Exempt Persons, Authorized Persons or Investment Institutions, as defined in the relevant implementing regulations issued by the Capital Markets Authority (CMA). In the United Arab Emirates this material is only intended for -natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. In the State of Kuwait, those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. In the Sultanate of Oman, to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. In Qatar, for distribution with pre-selected institutional investors or high net worth investors. In the Kingdom of Bahrain, to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. The information contained in this document, does not constitute and should not be construed as an offer of, invitation, inducement or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. In Singapore, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. In Hong Kong, this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. In South Korea, this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital MarketAct and its sub-regulations). In Taiwan, independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. In Japan, this is issued by BlackRock Japan. Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). In Australia, issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL). The material provides general information only and does not take into account your individual objectives, financial situation, needs or circumstances. In China, this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. For Other APAC Countries, this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions). In Latin America, for institutional investors and financial intermediaries only (not for public distribution). No securities regulator within Latin America has confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico thus is subject to strict rules. For more information on the Investment Advisory Services offered by BlackRock Mexico please refer to the Investment Services Guide available at www.blackrock.com/mx

©2020 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.



Not FDIC Insured • May Lose Value • No Bank Guarantee