Weekly commentary

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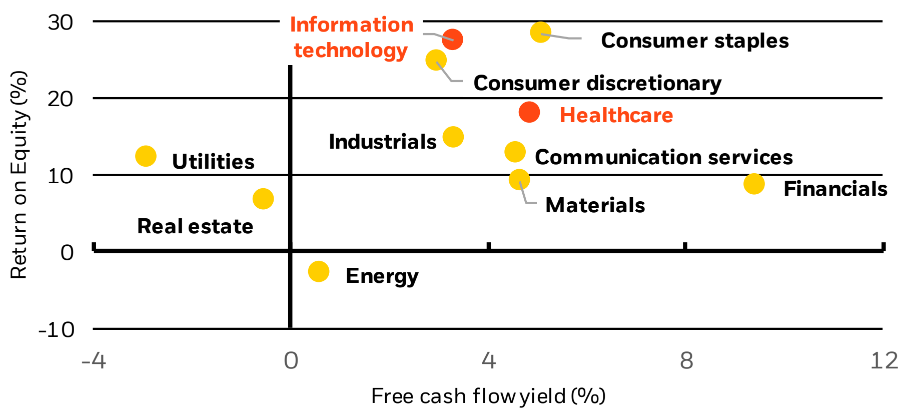
Why we favor tech and healthcare

- The pandemic has sped up structural trends that are benefiting sectors such as technology and healthcare – and we believe these trends are not fully priced in.
- Rising inflation expectations have driven up U.S. 10-year Treasury yields but to a lesser degree than in the past, in line with our new nominal theme.
- Data on credit growth in China this week could shed light on the degree of ongoing policy support amid softening economic activity.

The pandemic has turbocharged transformations that were already under way – from sustainability to inequality. Yet markets have not fully priced in the durability of these trends, we believe, even with the glimpse into the future offered by the pandemic. We favor technology and healthcare on a tactical horizon, as they offer both quality characteristics and are likely beneficiaries of structural growth trends.

Chart of the week

Return on equity and free cash flow yields of U.S. stocks by sector, 2021



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, February 2021. Notes: U.S. stocks are represented by the MSCI USA Index. Data are based on a trailing 12-month basis. The free cash flow yield of financials isn't comparable to others due to the sector's unique nature.

Healthcare and technology led the U.S. stock market in generating earnings and revenue growth in 2020. They also stand out in generating high free cash flow yields and return on equity, as the chart shows. The quality characteristics of these two sectors could help provide some resilience against any bumps along the road to the economic restart, in our view. At the same time, they offer long-term growth potential given structural shifts such as digitalization and aging societies. Such quality exposures sit on one side of our bar-belled approach to tactical asset allocation; on the other side, we like selected cyclical exposures such as emerging market equities and U.S. small caps, which we see as benefiting from a vaccine-led restart. Market pricing has come a long way since late last year, yet we still see accelerated structural trends not yet fully reflected. We believe they could drive performance over the tactical horizon. History suggests financial markets are imperfect at pricing in long-term trends, even when these shifts – such as demographic changes – are expected long in advance.

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Stock markets have hit new highs, led by the steady outperformance of tech stocks. We don't see overall equity valuations as obviously stretched, as we expect low interest rates and a vaccine-led economic restart to support risk assets over the next six to 12 months. We also see sector-specific drivers for growth. The pandemic has made the case for accelerating the shift to digital across a broad range of industries. One factor to consider: Rising production costs amid the rewiring of global supply chains – another structural trend reinforced by the pandemic – has made cost-saving technology investment a priority over traditional capex. Other trends are also supportive of the sector. About 38% of the U.S. workforce teleworked in early-mid January, according to the U.S. Census Bureau. We expect the share of employees working remotely at least part-time to fall once the restart materializes – but to remain above the pre-pandemic levels. This shift improves the outlook for companies behind the software, cloud and security infrastructure necessary to support a more dispersed workforce.

We see the healthcare sector potentially benefitting from structural trends such as demographic shifts, emerging market healthcare spending growth and innovation across the board. For example, telemedicine has gained popularity during the pandemic, and could become a long-term solution for some care needs due to its cost and operational efficiency. We also see the relatively low valuation of the healthcare sector as appealing, and the risk of major policy change in the U.S. appears low given Democrats' slim majority in the Senate. An expansion of Obamacare could be positive for the managed healthcare industry in the U.S, or health insurance providers. Elsewhere in the sector, the pandemic has hit demand for elective procedures and cancer care. A vaccine-led economic restart would likely help drive a rebound in these businesses.

Another key trend is the tectonic shift toward sustainable investing. We will soon incorporate climate considerations into our capital market assumptions – our long-run estimates of risk and return – to help investors prepare their portfolios for a transition to a lower carbon economy. Read our CEO Larry Fink's 2021 letter to CEOs on BlackRock's commitment.

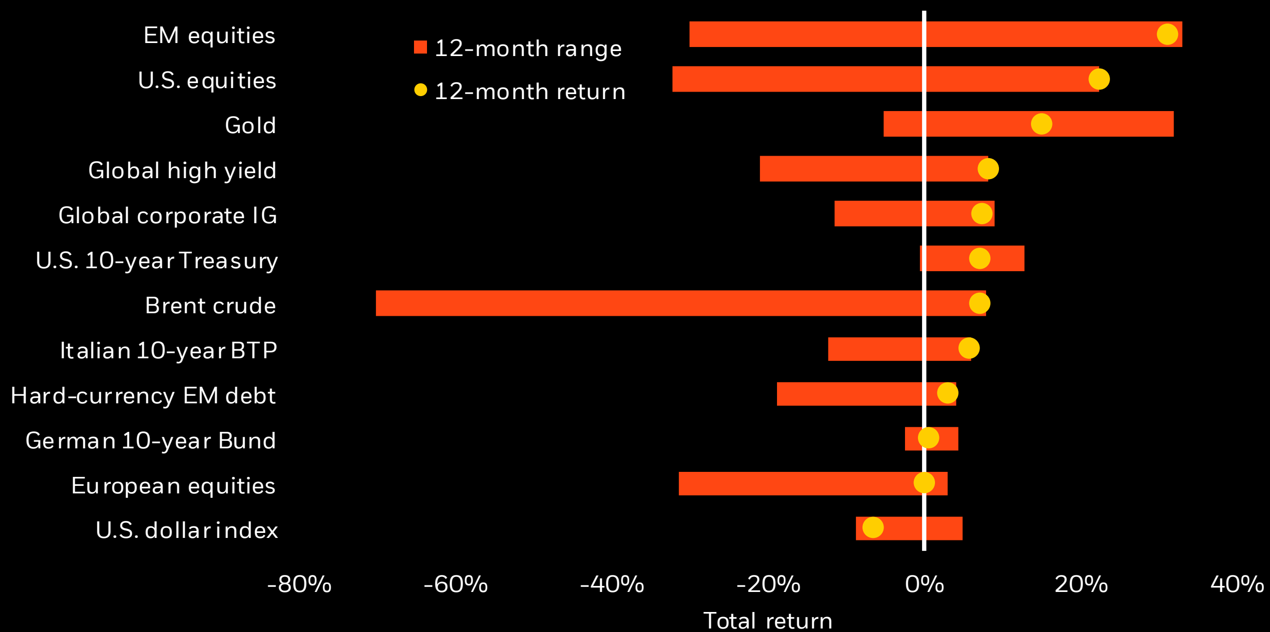
The bottom line: We favor tech and healthcare in tactical portfolios for their quality characteristics and the potential to benefit from long-term structural trends. A risk to our view: The pandemic has afforded greater visibility into future trends, yet more of this may now be priced in – and our visibility is still imperfect; some trends could reverse or change over time.

Market backdrop

U.S. stocks hit record highs as Congress made progress on the $1.9 trillion spending plan. U.S. 10-year Treasury yields rose to the highest levels since last March, yet the magnitude of the increase is much less than that in the corresponding inflation expectation during the period. Inflation-adjusted yields have been negative and stable – in line with our *new nominal* theme. Former European Central Bank President Mario Draghi has been tapped to form a new Italian government, pushing Italian government bonds yields down.

Assets in review

Selected asset performance in the past 12 months



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, February 2021. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared with 12 months earlier. 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 US. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

Macro insights

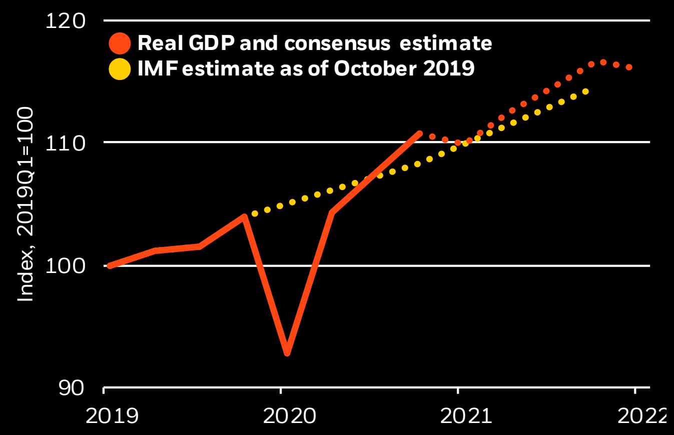
China has led the post-Covid activity restart globally – cementing its position as one of the two main engines of global activity – and underpinning our *Globalization rewired* theme. China will likely emerge as the only large economy globally with positive annual growth in calendar year 2020. The swift activity rebound has helped Q4 2020 GDP to return to pre-Covid trend, as shown on the chart.

We view the softer-than-expected activity data in January as a mild speed bump. Tighter virus restrictions, colder weather and a gradual normalizing of policy as authorities turn their focus back to longer-term reforms have played a part. Yet a narrow focus on Chinese GDP growth rates misses a more important shift to *quality* of growth from the *quantity* of growth, in our view.

The forthcoming National People's Congress – that begins on March 5 – will likely focus on longer-term issues such as the control of financial risks, paving the way for stronger creditor protections and streamlined bankruptcy measures.

China's recovery

Estimated and actual real GDP growth in China, 2019-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, IMF and China's National Bureau of Statistics, February 2021. Notes: The orange line shows the actual GDP up to Q4 2020 (from the NBS) and estimated real GDP (dotted line) for China. Consensus estimates are based on the latest Reuters poll of economists. The yellow line shows the implied path of China's real GDP projected by the IMF in its World Economic Outlook in Oct 2019.

Investment themes

1 The new nominal

- We see stronger growth and negative 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.
- The Democrats' slim majority in U.S. Congress improves the outlook for fiscal spending, likely fast tracking our expectations for stronger growth and negative real yields.
- Medium-term inflation risks look underappreciated. Production costs are set to rise amid the rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- The policy revolution has led to a surge in public debt – and increased tolerance for it. We don't see high debt levels as a concern in the near term. Yet there are risks bubbling below the surface – over time we could see a change in the premium for the perceived safety of government debt, with major market implications.
- **Market implication**: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by negative 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. We believe investors need exposure to both poles of global growth.
- Strategic U.S.-China rivalry looks here to stay, particularly in tech. The Biden administration is likely to shift away from a focus on bilateral trade deficits to a multi-lateral approach. It will also seek to balance cooperation on climate change and public health within a broader U.S.-China agenda that includes areas of potential heightened tensions such as trade and human rights.
- 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. We see tech as having long-term structural tailwinds despite its increased valuations, yet it could face challenges from higher corporate taxes and tighter regulation under a united Democratic government.
- 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

Feb. 8–15 China total social financing data

Feb. 12 University of Michigan Surveys of Consumers

China's Total Social Financing data – a broad measure of credit and liquidity growth in the world's second largest economy – will be in focus, after weaker-than-expected data last month. The data could shed light on ongoing policy support amid softer activity data as virus restrictions have tightened. In the U.S., the preliminary University of Michigan survey data will be key to watch for signs of a consumption boost following renewed fiscal policy support.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, January 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
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 are overweight equities 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, January 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, January 2021

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities. 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 are underweight European equities. 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 U.S. dollar and more stable trade policy under a Biden administration.
	Asia ex-Japan		■	We are overweight Asia ex-Japan equities. Many Asian countries have been more effective at containing 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 has become more exposed to cyclicality, could face challenges in the near term as a resurgence in Covid-19 cases and a slow start to the vaccination efforts create potential for choppy markets.
	Value			We are neutral on value despite its recent outperformance. 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.
	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.
Fixed Income	U.S. Treasuries	■		We are underweight U.S. Treasuries. We see a muted response in nominal U.S. yields to rising inflation expectations, and real yields staying in negative territory. 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, significant fiscal spending, 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 political events in Italy. We see further rate compression due to ongoing support from the European Central Bank and other policy actions.
	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 high yield and Asia fixed income.
	Global high yield		■	We are moderately overweight 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 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.
	Emerging market – local currency			We are neutral local-currency EM debt. 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.

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