Weekly commentary

March 1, 2021

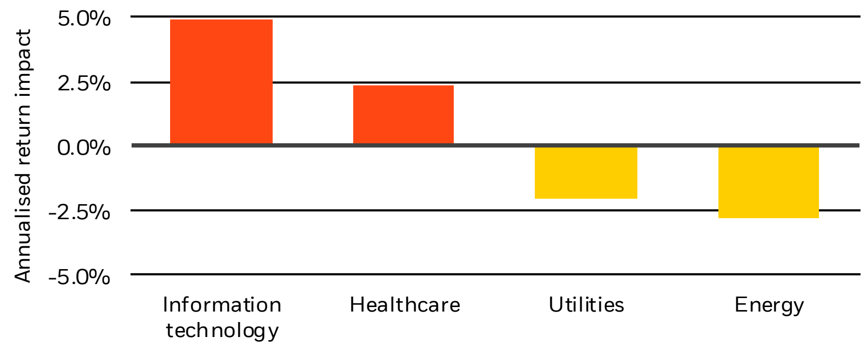
Climate transition: a driver of returns

- Our updated, climate-aware return assumptions support our strategic preference for developed market (DM) equities.
- Rising inflation expectations have driven up U.S. 10-year Treasury yields but to a lesser degree than in the past. Real yields remain deep in negative territory.
- U.S. nonfarm payrolls data will be in focus after a modest increase of jobs in January. Global purchasing managers index data will shed light on the restart.

We are incorporating the effects of climate change – and of the climate transition – in our return assumptions, as we believe avoiding climate-related damages will help drive growth and improve returns for risk assets. We see climate-resilient sectors as potential beneficiaries of a "green" transition and are strategically overweight DM equities as they are skewed toward these sectors.

Chart of the week

Return assumption differentials in green transition vs. no-climate-action



For illustrative purposes only. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Bloomberg, February 2021. Notes: The chart shows the difference in U.S. dollar expected returns over the next five years from February 2021 for four sectors of the MSCI USA Index in our base case of a "green" transition (policies and actions taken to mitigate climate change and damages, and to limit temperature rises to no more than 2 degrees Celsius by 2100) vs. a no-climate-action scenario. The estimated sectoral impact is based on expected differences in economic growth, corporates earnings and asset valuations across the two scenarios. Professional investors can access full details in our *Portfolio perspectives* and CMAs website.

We see climate change and efforts to curb it having major economic implications in the decades to come. The base case underpinning our updated capital market assumptions (CMAs) reflects a "green" transition to a low-carbon economy, with a gradual phasing-in of carbon taxes, green infrastructure spending consistent with the IMF's recommendation, and subsidies on renewable energy. If none of these actions are taken to mitigate climate change, we estimate a cumulative loss in global output of nearly 25% in the next two decades. Our updated CMAs are driven by sectoral views, with exposure to climate risks and opportunities a key determinant. We see technology and healthcare benefiting the most from that perspective, and carbon-intensive sectors with less transition opportunities such as energy and utilities lagging. See the chart for estimated return assumptions of four sectors in our base case vs. a no-climate-action scenario. Climate is just one driver of asset returns. Other drivers such as valuation could be more powerful over the short term, as evidenced by energy's strong performance so far this year.

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BlackRock **Investment** Institute

Our updated CMAs are an important step in BlackRock's journey of making sustainability core to our investment process, as highlighted in CEO Larry Fink's annual letter. The journey started long before this year. We had laid down the case for sustainability as a driver of asset class returns in Sustainability: the tectonic shift transforming investing, and have developed new tools to assess physical risks to assets caused by climate change. We already experience the effects of climate change in our daily lives, in the form of extreme weather events and rising temperatures. Capturing the financial implications is not easy, but it cannot be ignored. Projections around climate change are highly uncertain. This is due to the complexity of modelling the dynamics and myriad dependencies between climate, carbon emissions, and economic variables. We are in uncharted territory. Systematic acknowledgement of the inherent uncertainty is therefore crucial, and is a key consideration when we consider the portfolio implications.

We refine our CMAs to include an important and often underappreciated return driver - climate change. This flows in to our CMAs through 3 channels: 1) the macroeconomic impact; 2) the repricing of assets to reflect climate risks and exposures, and; 3) the impact on corporate fundamentals. First, macro variables such as GDP growth will be different in a world that is transitioning to a low-carbon future, meaning traditional risk premia for all asset classes will change, in our view. Second, we don't believe market prices yet reflect the coming "green" transition, meaning assets poised to benefit may have a higher return during the transition. Third, climate change and the efforts to address it will impact the profitability and growth prospects of companies, creating winners and losers.

The bottom line: We believe the transition toward a world with net-zero carbon emissions should reward companies, sectors and regions that adjust, and penalize others. These effects are now reflected in our climate-aware return assumptions. On a broad asset class level, we see DM equities positioned to capture the potential opportunities from the climate transition, at the expense of high yield and some emerging market debt. The composition of DM equity indexes is more skewed toward less carbon-intensive sectors such as tech and healthcare; equities also can better capture potential opportunities arising from the "green" transition, given that bonds have more limited scope for capital appreciation, in our view.

Market backdrop

U.S. 10-year Treasury yields hit the highest levels in nearly a year. Nominal yields have been climbing since September, but the magnitude has lagged that of the rise in inflation expectations during the period. Inflation-adjusted yields remain deep in negative territory – in line with our *new nominal* theme. U.S. stocks came under pressure as Treasury yields rose. We still believe the *new nominal* will support equities and risk assets over the next six to 12 months.

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, February 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 Emerging Markets Index, MSCI Europe Index, MSCI USA Index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), 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, J.P. Morgan EMBI index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

Overall consumer spending is likely to return to its pre-Covid trend as pent-up demand is unleashed, in our view. Yet its composition will likely look different as Covid-inspired shifts in consumer behavior take hold. We see three reasons why the restart in the consumer sector may be different from a typical business cycle recovery.

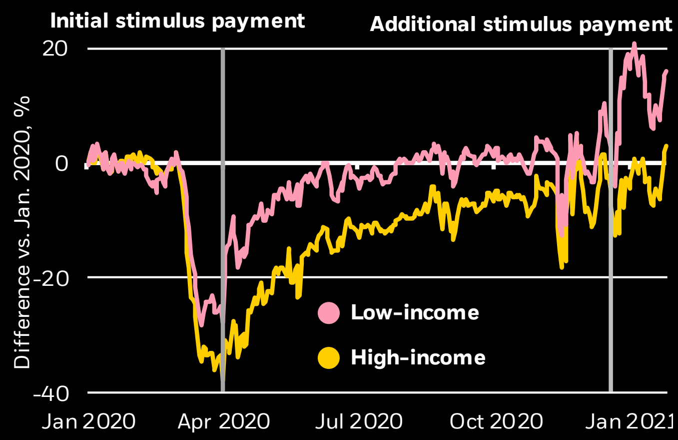
First, spending will likely recover much more quickly as vaccine-led easing of restrictions paves the way for the level of activity to normalize.

Second, consumer balance sheets have been healthy thanks to unprecedented policy support – avoiding the kind of deleveraging shock seen in the global financial crisis that depressed spending. Stimulus payments are already boosting consumption – especially for low-income groups – according to high-frequency credit card transaction data. See the chart to the right.

Third, the shock has turbocharged transformations already underway in spending – such as a shift to e-commerce, a trend we see staying in place even as restrictions ease.

Consumption check

U.S. consumer spending by income group, February 2021



Sources: BlackRock Investment Institute, with data from Opportunity Insights, February 2021. Notes: The chart shows U.S. consumer spending by income group based on high-frequency credit card transaction data, compared to the levels in January 2020.

Investment themes

1 The new nominal

- We see a more muted response of government bond yields to stronger growth and higher inflation than in the past, as central banks lean against any sharp yield rises. We believe this should support risk assets, even as the restart takes shape.
- 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**: We favor inflation-linked bonds amid inflationary pressures in the medium term. Tactically we prefer to take risk in equities over credit amid low rates and tight spreads.

2 Globalization rewired

- Covid-19 has accelerated geopolitical transformations such as a bipolar U.S.-China world order and a rewiring of global supply chains, placing greater weight on resilience.
- 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 case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe 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 developments have been incrementally positive over the past 12 months, and investors are compensated for these risks.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like Asia ex-Japan equities, and see UK equities as an inexpensive, cyclical exposure.

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 strong performance 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 see returns being driven by climate change impacts, and view developed market equities as an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

March 1	Manufacturing purchasing managers' index (PMI) for Japan, China, the euro area and the U.S.	**March 3**	Services PMI for Japan, China and the U.S.; euro area composite PMI
March 4	U.S. factory orders	**March 5**	U.S. nonfarm payrolls; China's annual National People's Congress session starts

U.S. nonfarm payrolls data will be in focus. Economists polled by Reuters expected February's nonfarm payrolls to increase by 110,000 jobs, after a modest gain of 49,000 in the previous month. Global PMI data will also help shed light on the restart status, especially in the services sector where activity has been muted.

Directional views

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

Asset	Strategic view	Tactical view	Change in view: Previous → New
Equities	+1	+1	We turn 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 indexes. 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 bias for quality.
Credit	-1	Neutral	We are underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we downgrade credit to neutral following the tightening in spreads, particularly investment grade. We still like high yield for income.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and 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 as we see risks of higher inflation in the medium term. We turn underweight duration on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart.
Cash		Neutral	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.
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 not suitable for all investors.

Note: Views are from a U.S. dollar perspective, February 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, February 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.
Equities	Euro area			We turn neutral European equities. We believe that there is room for the market to close the valuation gap vs. the rest of the world as the economic restart becomes more entrenched.
Equities	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
Equities	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.
Equities	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.
Equities	UK			We are overweight UK equities. The removal of uncertainty over a Brexit deal should see the risk premium on UK assets attached to that outcome erode. We also see UK large-caps as a relatively attractive play on the global cyclical recovery as it has lagged peers.
Equities	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.
Equities	Value			We are neutral on value despite recent underperformance. 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.
Equities	Minimum volatility			We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol has historically lagged in such an environment.
Equities	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.
Equities	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 may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields rising but largely due to a repricing higher of inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Euro area peripherals			We are closing our overweight to euro peripheral bond markets that we have held since April 2020. Yields have rallied to near record lows and spreads have narrowed. The ECB supports the market but it is not price-agnostic - its purchases have eased as spreads have narrowed.
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 high yield and Asia fixed income.
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.
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 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.
Fixed Income	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.

BlackRock Investment Institute

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