Weekly commentary

BlackRock

March 8, 2021

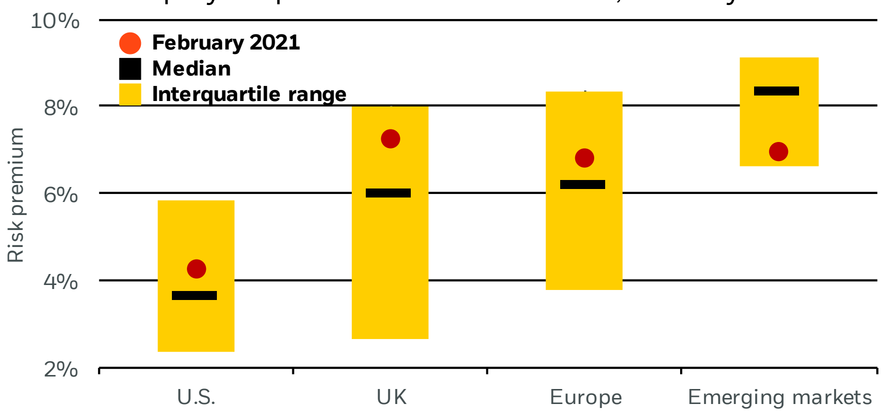
Leaning further into cyclicality

- We have recently broadened our tactical pro-cyclical stance, including an overweight call on UK equities and upgrading European equities to neutral.
- Nominal yields have risen over the past year - initially driven by higher inflation expectations but more recently by a jump in real yields.
- Markets will closely watch the European Central Bank (ECB) policy meeting this week to see if it pushes back against the recent rise in government bond yields.

The UK has led the developed world in the pace of its vaccine rollout, with the euro area set to catch up after a slower start. Vaccine rollouts and fiscal spending are paving the way for an accelerated global restart, reflected in a recent rise in real rates. This supports a broadening of the cyclical tilt in our tactical views, with our recent debut of a UK equities overweight and upgrading euro equities to neutral.

Chart of the week

Estimated equity risk premia in selected markets, February 2021



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. You cannot invest directly in an index. Sources: BlackRock Investment Institute and Refinitiv Datastream, data as of Feb. 26, 2021. Notes: The chart shows the estimated equity risk premia and historical ranges since December 1997 for selected equity markets, represented by MSCI USA, MSCI UK, MSCI Europe (euro), and MSCI Emerging Markets Indexes. We calculate the equity risk premium based on our expectations for nominal interest rates and the implied cost of capital for respective equity markets.

UK and euro area stocks lagged the global market in 2020. UK stocks, skewed toward sectors that typically fare poorly during cyclical downturns and weighed down by Brexit uncertainties, were the worst performer among developed market (DM) peers. With the risk of a no-deal Brexit lifted and the UK leading the vaccine rollout among DMs, we see a broad activity restart in the summer. Unprecedented UK fiscal support – which the government plans to keep in place – has helped to minimize long-term economic scarring, reinforcing our positive view on this market. We see the euro area restart lagging that of the UK or U.S. by a few months, given its slower-than-expected vaccine rollout, but this leaves room for a catch-up. In addition to the positive macro backdrop, we see valuations in these two markets as supportive, based on our estimates of the equity risk premium, our preferred valuation gauge that accounts for changes in the risk-free rate. See the chart above.

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BlackRock **Investment** Institute

We expect a vaccine-led reopening to enable activity to return to pre-Covid levels by late 2021 or early 2022 in the euro area and the UK, with a well of pent-up demand fueling spending, especially in services. Activity data last week were stronger than expected, suggesting services have not been as severely hit as by the initial lockdowns as in 2020. We see ongoing fiscal support for the most affected households and sectors, and expect central banks to keep financial conditions easy. We expect the ECB to likely reiterate such a commitment at this week's policy meeting, pushing back against higher bond yields.

Recent earnings suggest an improving outlook for European and UK companies. More European companies have beat earnings expectations in the fourth quarter of 2020 than ever – albeit versus moderate expectations – accompanied by an improving margin picture. Cyclical exposures such as materials and energy have posted the strongest upward earnings revisions, lending additional support.

Rising government bond yields recently have put pressure on equities. Yet we see UK and European equities relatively well placed in this environment, as our research shows equity prices are typically less sensitive to rising rates when valuations are low, or the ERP is high. More broadly, we don't see rising nominal yields as a source of worry as long as our *new nominal* theme holds, with a more muted central bank response against inflation than in the past – and monetary authorities leaning against any excessively rapid increases in real yields. The recent increase in real yields, in our view, reflects expectations for a stronger economic restart and underpins the recent broadening of our pro-cyclical stance.

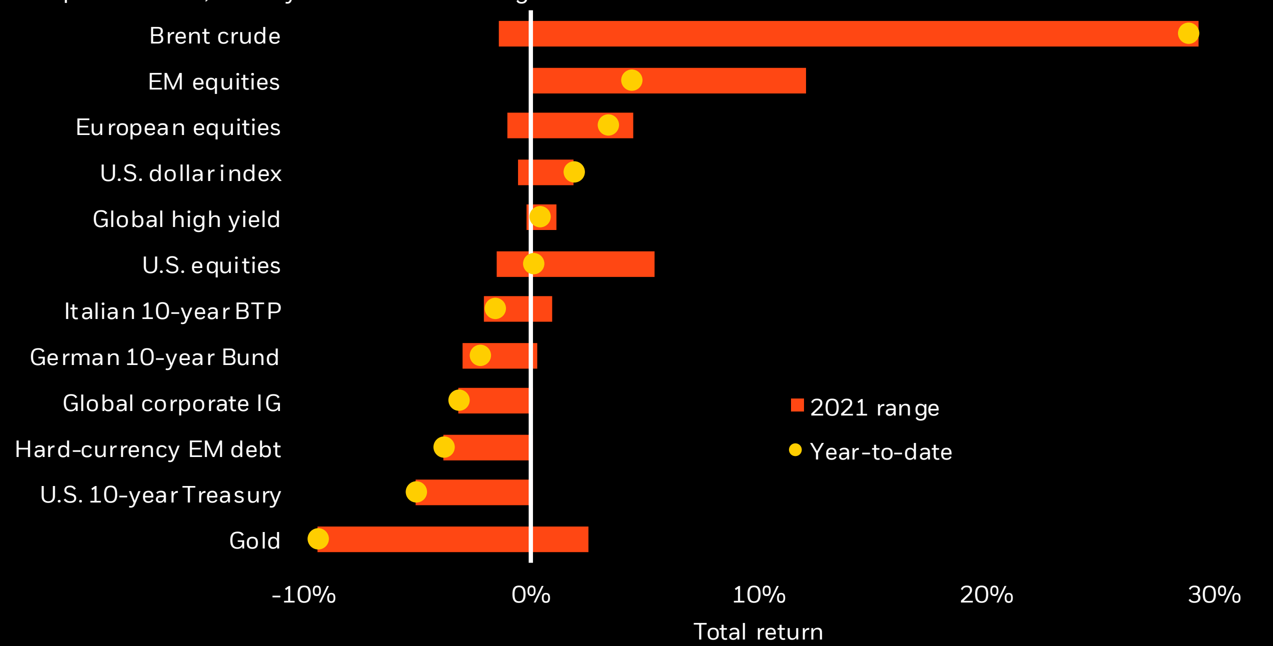
The bottom line: We have broadened our pro-cyclical stance over the tactical horizon as we expect a rapid activity restart later this year and into 2022. As a result we are overweight UK equities and have upgraded euro area equities to neutral. We also recently downgraded euro area peripheral bonds to neutral, as yield spreads have narrowed. Overall, we prefer equities over credit over the tactical horizon given the relatively more attractive valuations in equities. European companies have also made strides in the shift towards sustainability, positioning them well for the transition to a zero-carbon economy that we see as a key driver of asset returns over the strategic horizon.

Market backdrop

U.S. 10-year Treasury yields hit the highest level since last February, putting pressure on the stock market. 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. 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, March 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, the ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI USA Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, J.P. Morgan EMBI index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

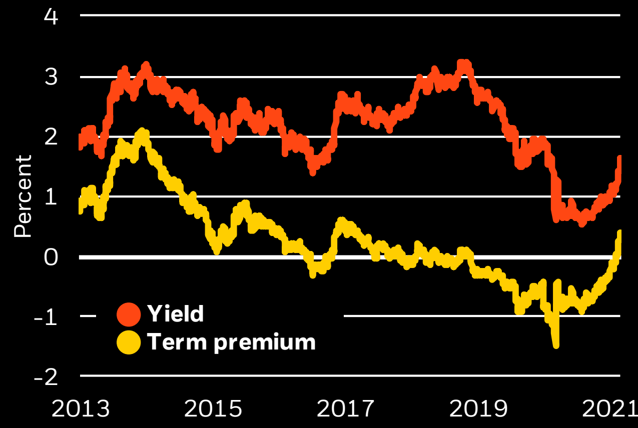
Macro insights

The recent surge in U.S. bond yields has brought the outlook for monetary policy into focus. Federal Reserve officials have insisted on "patience" with policy, even as financial markets are eyeing a robust restart – one that may be taking place sooner in the U.S. with its vaccination rollout. The yield rises have sometimes sparked pullbacks in stocks. Is this a replay of the 2013 "taper tantrum," when former Fed Chair Ben Bernanke first floated the idea of trimming the central bank's bond purchases?

We don't think so – at least for now. This looks more like a "tantrum" in the term premium – the premium investors typically demand for the risk of holding long-term bonds – rather than a sharp reset of market expectations for the Fed raising policy rates. The chart shows how the rise in term premium has matched the rise in nominal 10-year U.S. Treasury yields. Our *new nominal* theme is based on the view that central banks will be less responsive to higher growth and inflation relative to the past. The upshot? Risk-free short-term rates, key to asset valuations, will likely stay lower for longer. For more see https://blackrock.com/macro

Risk perceptions

U.S. 10-year yield and term premium, 2013-2021



Past performance is not a reliable indicator of current or future results. Sources: BlackRock Investment Institute and Federal Reserve Bank of New York, with data from Haver Analytics, March 2021. Notes: This chart shows our estimate of the term premium in the U.S. 10-year Treasury note using a New York Fed model of the term structure, or the relationship between short- and long-term interest rates.

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 11 ECB policy meeting

March 12 University of Michigan Surveys of Consumers

March 8–15 China total social financing and new yuan loans

The ECB policy meeting will be in focus after the spike in U.S. government bond yields have driven up global yields. We expect the central bank to reaffirm its intention to keep policy easy until the effects of the pandemic are past and inflation is sustainably back at target. University of Michigan consumer sentiment survey could shed light on the status of the restart as some states have started to ease restrictions.

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 the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
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.

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