Weekly commentary

BlackRock

April 19, 2021

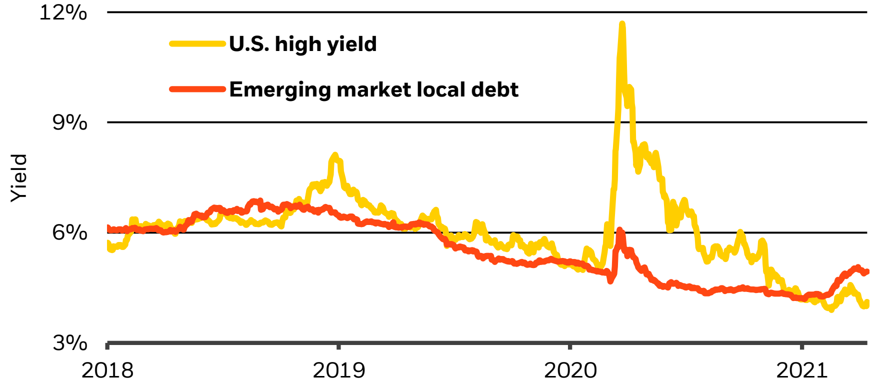
Why we like emerging market assets

- We see the restart, stabilizing U.S. Treasury yields and relatively cheap valuations boosting emerging market (EM) assets after a choppy start to 2021.
- U.S. stocks hit record highs and 10-year Treasury yields fell to the lowest level in more than a month. Major U.S. banks reported positive first-quarter earnings.
- Purchasing managers' index (PMI) data from key developed economies this week could shed light on the state of the economic restart.

We see the economic restart and greater stability in U.S. government bond yields - as indicated by our *new nominal* theme - supporting emerging market assets over coming months. Their valuations appear relatively attractive in a world of low yields after a choppy start to the year. Risks to our view include potential policy tightening and sluggish vaccine rollouts in some EMs.

Chart of the week

Yields of U.S. high yield debt and EM local-currency debt, 2018-2021



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, with data from Refinitiv, April 2021. Notes: U.S. high yield debt is represented by the Bloomberg Barclays U.S. Corporate High Yield Index, and EM local-currency debt by the JPMorgan GBI-EM Global Diversified Index.

U.S. Treasury yields and the U.S. dollar are key drivers for EM assets. Treasury yields spiked earlier in the year, leading to a sharp rise in EM yields. We think the spike was justified and reflected the faster-than-expected activity restart combined with large U.S. fiscal stimulus. We see greater stability in yields and in the U.S. dollar over coming months, with our *new nominal* theme confirmed by the Federal Reserve's comments and recent market moves. This should support EM local-currency debt, in our view. Its valuation appears attractive relative to other income sources such as high yield debt, as the chart above shows. Support also comes from loose global financial conditions that make it relatively easy to borrow for now, and reduced foreign ownership in this market that helps keep contagion risk in check. We also see room for EM currencies – especially from commodity exporters - to advance, as these currencies have yet to fully reflect the commodity rally. There is a large dispersion within EM fundamentals and that demands a selective approach. See our Emerging markets marker.

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute

Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

Beata Harasim
Senior Investment Strategist -BlackRock Investment Institute

Some EMs face near-term challenges including a virus resurgence, slow vaccine rollouts and rising inflation that may force the hand of their central banks. Yet we expect their economic restart to likely be delayed – but not derailed. We are overall positive on broad EM and Asia ex-Japan equities in particular over the next six to 12 months, expecting these assets to be well positioned to benefit from a vaccine-led global restart. We also see the need to be selective in EM equities. The powerful economic restart is likely to support many commodities in the near term, including oil. This should benefit the assets of commodity exporters, including some EMs, as we argued last week. Copper prices have rallied since last year as a result of a supply shortage and activity restart in key consumers including China. We see structural demand for copper and certain industrial metals associated with a transition toward a low-carbon economy for years to come. This should support prices and likely benefit EM exporters of copper and other commodities, in our view.

We see China exposures as core strategic holdings that are distinct from EM exposures. There are near-term risks in China including an anti-monopoly drive that threatens large-cap Internet companies – a large component of EM benchmark indexes - that pushes us to favour more cyclical and domestically oriented exposures. And even with such risks we still favor strategic above-benchmark allocations to assets exposed to China, including Chinese equities and government bonds. The pandemic has accelerated the rewiring of globalization – with a bipolar U.S.-China world order at its center. We believe it's key for investors to have exposures to both engines of global growth.

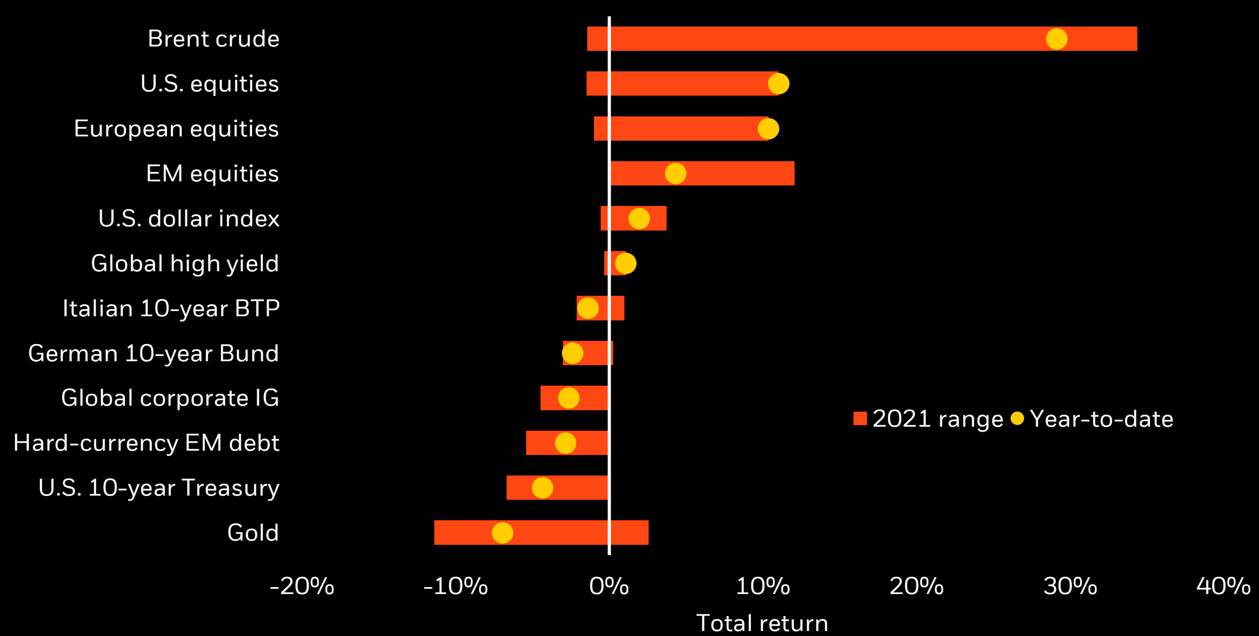
The bottom line: We expect our *new nominal* theme – a more muted response in nominal yields to higher inflation expectations - to hold as we move toward a full reopening. The U.S. dollar has strengthened so far this year, reflecting the faster-than-expected restart in the U.S. fueled by an accelerated vaccine rollout and large fiscal spending. We expect the rise in the dollar to take a pause as markets start reflecting expectations for the reopening to broaden out, easing some pressure on EM assets. We stay overweight EM and Asia ex-Japan equities, and are warming up to EM local-currency debt as a source of income. Potential risks to our views include the deteriorating creditworthiness of many EMs as a result of massive fiscal expansion last year. Policymakers in these countries may be faced with the challenge of needing to tighten policies even as their economies still operate well below potential.

Market backdrop

U.S. stocks hit new record highs and 10-year Treasury yields dropped to the lowest level in more than a month. Major U.S. banks reported positive earnings for the first quarter. We expect equities and other risk assets to be supported by the *new nominal* – a more muted response of government yields to stronger growth and higher inflation than in the past as central banks lean against any sharp yield rises.

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 April 15, 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, MSCI Emerging Markets Index, the ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield 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

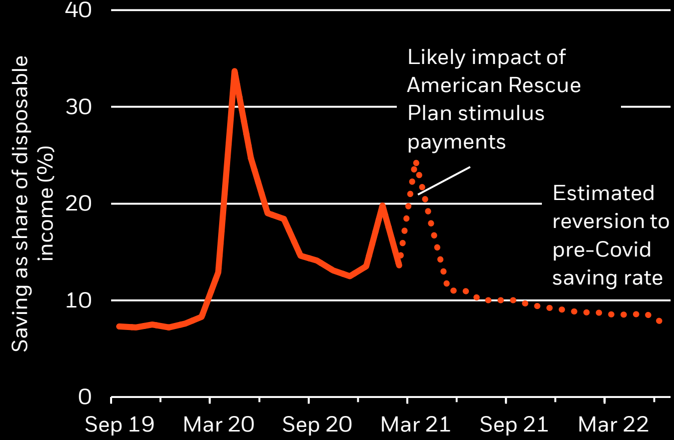
A rapid restart in consumption will be key to the U.S. economy returning to its pre-Covid trend by the end of the year. We expect the pent-up demand built up since last year among U.S. consumers to unleash as the economic reopening forges ahead on the back of an accelerated vaccine rollout.

Consumer spending collapsed when lockdowns were introduced early last year, yet the saving rate surged partly thanks to stimulus payment driving up aggregate income. See the chart. Most of the increase in the saving rate likely reflects "forced" saving as consumption fell in response to lockdowns and not due to a shortfall of demand, in our view.

As the economy reopens, the opportunities to spend expand. The expected strength of the job market rebound will likely lead to greater confidence to spend, reducing precautionary savings, in our view. We expect consumer spending to return to its pre-Covid trend by the middle of 2021 – followed by an overshoot. This means consumer spending could pick up the baton just when the boost from fiscal policy to sequential GDP growth starts to fade.

Saving it up

Savings as share of disposable income, 2019-2021



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, with data from Haver Analytics, April 2021. Notes: The chart shows U.S. personal savings as a share of disposable personal income. The dotted line shows our estimate of the path for savings rate to revert to its pre-Covid level by March 2022.

Investment themes

1 The new nominal

- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – has been confirmed by the Fed's March policy meeting. The Fed made it clear that the bar for reassessing its policy rate path was not met and that it was too soon to talk about tapering bond purchases, while embracing a material improvement in its outlook. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation and to wait to see it move above target has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **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.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- 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 and U.S.-China conflicts, but we believe 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

April 22 European Central Bank (ECB) policy meeting; euro area consumer confidence

April 23 U.S., euro area, UK and Japan composite purchasing managers' index (PMI)

This week's PMI data from key developed economies could help gauge the progress of the economic restart. We expect the pent-up demand among U.S. consumers to unleash with the accelerated vaccine rollout, benefitting contact-intensive services. We don't expect any policy change from the ECB's policy meeting, after it decided to increase the pace of bond purchases under its Pandemic Emergency Purchase Program (PEPP) to stem a rise in bond yields at the March meeting.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are 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, credit, especially investment grade, has come under pressure from tightening spreads, but 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 are 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.

Notes: Views are from a U.S. dollar perspective, April 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, April 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 are 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 neutral euro peripheral bond markets. 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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