

Weekly commentary

March 22, 2021



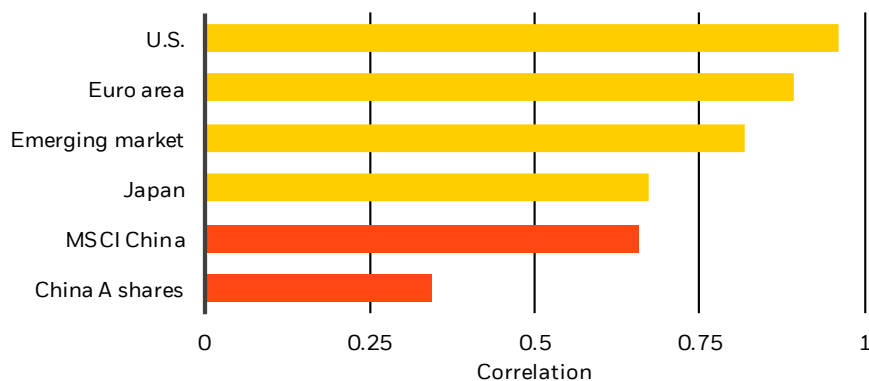
Our views on Chinese assets

- We still favor above-benchmark strategic allocations to China exposures, and see the recent weakness in Chinese markets offering an attractive entry point.
- The Federal Reserve made clear its commitment to be well “behind the curve” on inflation and wait to see it to materialize.
- Investors will focus on the flash composite purchasing managers’ index data for major developed economies to gauge the status of the activity restart.

Chinese stocks have sold off on concerns that China could tighten monetary and fiscal policy more aggressively – after having led the global restart and policy normalization. This took place as rising U.S. Treasury yields have pressured global risk assets. We see moderately reduced tightening risk after China’s parliament meeting, and keep an above-benchmark strategic allocation to China exposures.

Chart of the week

Correlation of selected equity indexes with MSCI World Index, 2011-2021



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, March 2021. Notes: The chart shows the correlation of weekly returns between each market and the MSCI World Index, on a U.S. dollar basis. The indexes used, in descending order, are the MSCI USA, MSCI EMU, MSCI Emerging Markets, MSCI Japan, MSCI China and MSCI China A Onshore Indexes.

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, and Chinese assets warrant greater than index weight allocations in strategic portfolios. China is still under-represented in global indexes – accounting for less than 10% of both the MSCI ACWI Index (including offshore shares) and Bloomberg Barclays Global Aggregate Bond Index. The relatively low correlation of Chinese assets with global peers offers attractive diversification benefits, in our view. Returns on China A-shares, for example, show a low correlation with developed market (DM) equities, as the chart above shows. The dynamic between Chinese government bonds and their global peers tells a similar story. Chinese government bond have held firm amid a sharp rise in global yields recently. Inflation-adjusted 10-year yields stand above 3%, still way above DM peers.



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China has recently lifted most domestic virus restrictions, paving the way for stronger growth – and further policy tightening. Recent better-than-expected Chinese data suggest markets may be underestimating the resilience of the economy. With a focus on improving the quality of economic growth, policymakers have shown a clear willingness to keep liquidity under control and allow occasional spikes in short-term rates – effectively moving in the opposite direction to the rest of the world. This hawkish policy bias has spooked markets, but it may have been largely reflected in pricing, in our view.

China’s leadership set a policy tone that was slightly more dovish than expected at the National People’s Congress (NPC) meeting earlier this month. This moderately reduces the risk of an over-tightening of both monetary and fiscal policy, in our view. The government also set a conservative GDP growth target of “above 6%” for 2021, suggesting it is not trying to maximize short-term growth but still believes a minimum level of growth is needed even as the focus shifts to quality growth. This conservative target also reflects two main uncertainties – the pandemic and U.S.-China tensions, in our view. 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 last week in Alaska.

The more confident Chinese policymakers appear on the macro outlook, the more risks could emerge on the micro level. China’s corporate default rates are lower than global averages, but a higher tolerance for market forces could shutter more “zombie firms” in credit markets; dominant companies in certain industries face risks due to an anti-monopoly campaign.

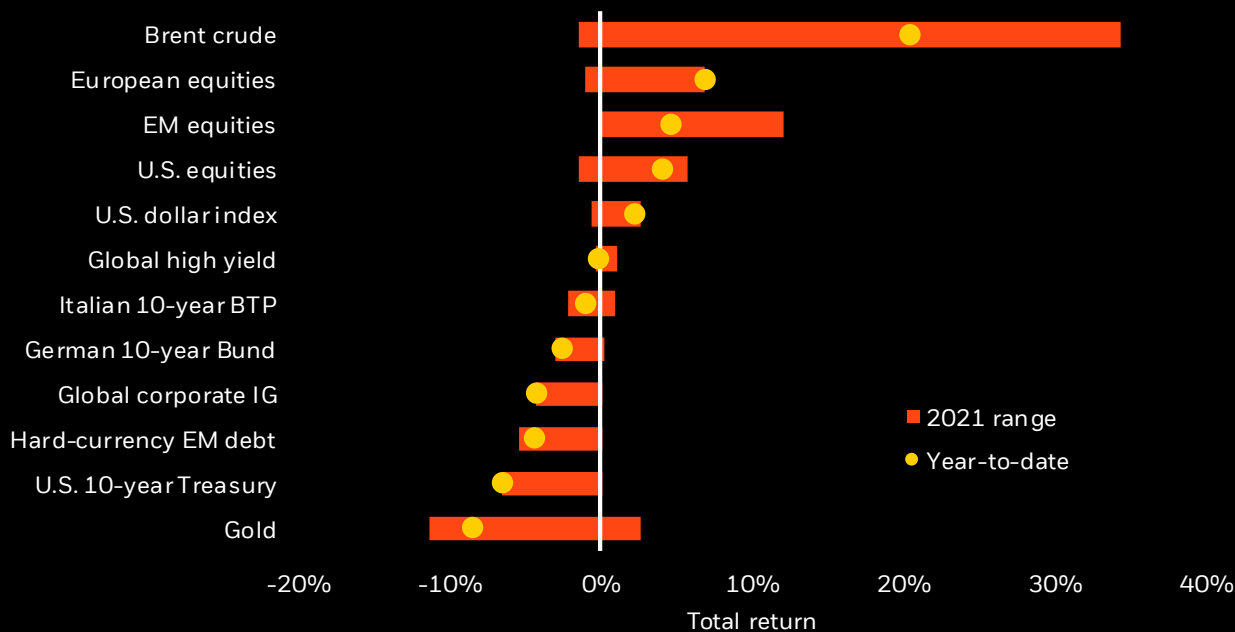
Even with these risks we see China exposures as core strategic holdings that are distinct from EM exposures. The recent market correction presents a better entry point and more attractive valuations, in our view. We see Chinese government bonds as attractive strategically despite narrowing spreads versus DM peers, and the country’s focus on quality growth should help produce higher-quality companies in the long run. Many Chinese industries are set to benefit from a climate transition as the country pursues its ambitious climate goal. Tactically our preference for Chinese assets is expressed via overweights to Asia ex-Japan equities and Asia fixed income – both heavily skewed toward China exposures. We see a repeat of last year’s strong performance as unlikely this year, yet the accelerated restart still bodes well for Chinese assets.

Market backdrop

The Federal Reserve embraced a material improvement in its outlook, while making clear that the bar for reassessing the policy rate path was not met and that it was too soon to talk about tapering bond purchases. This was a clear reaffirmation of its commitment to be well “behind the curve” on inflation and wait to see it to materialize. The rise in Treasury yields in recent months – while quick – is so far much more muted than we would have typically seen in the past. This is in line with our *new nominal* theme, which we expect to support equities and risk assets on the tactical horizon.

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 Europe Index, MSCI Emerging Markets Index, MSCI USA 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

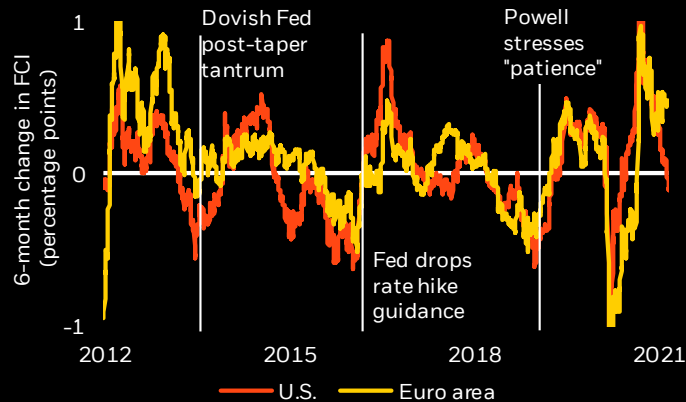
The Fed has made clear its higher tolerance for inflation overshoots. It has committed to keeping policy rates pinned near zero and signaled it was too soon to consider curbing bond purchases.

We believe the Fed needed to establish the credibility of its new higher tolerance for inflation while at the same time acknowledging the powerful economic restart. Fed Chair Jerome Powell said the only way to build credibility around the new policy framework is “by actually doing it”. We believe the clear reaffirmation of its commitment to be well “behind the curve” and wait to see actual inflation move above target has helped the Fed regain control of the narrative – for now.

The chart shows the Fed’s verbal interventions have typically occurred when the growth drag from tightening financial conditions is about half a percentage point, based on our [BlackRock financial conditions indicators](#). Last week the Fed showed that it is prepared to lean against premature expectations of higher rates sooner – and that it will be slower to lift rates than in the past. See our [macro insights hub](#).

Eyes on financial conditions

BlackRock financial conditions indicators, 2012-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2021. Notes: The chart shows the 6-month change in percentage points in our financial conditions indicators (FCI) for the U.S. and euro area. The FCIs give a forward view of where our Growth GPS – or the 12-month forward consensus GDP forecast may stand in three months’ time – may head and are expressed in GDP growth terms.

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

March 24

Flash composite purchasing managers' index (PMI) for Japan, the euro area, UK and the U.S.

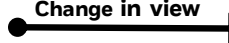


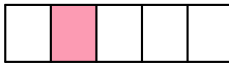

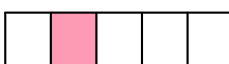
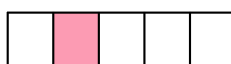


March 26

ifo Business Climate Index for Germany

This week's flash PMI data for key developed economies will be in focus. Investors are eager to gauge the level of activity restart, especially in the services sector that is most sensitive to virus dynamics. We expect the economic restart to re-accelerate significantly this year, as pent-up demand is unleashed and the vaccine rollout eventually enables activity to return to pre-pandemic levels.

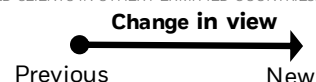
Directional views

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

Asset	Strategic view	Tactical view	Change in view 
			Previous New
Equities	 <p style="text-align: center;">+1</p>	 <p style="text-align: center;">+1</p> <p>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 cyclical and maintain a bias for quality.</p>	
Credit	 <p style="text-align: center;">-1</p>	 <p style="text-align: center;">Neutral</p> <p>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.</p>	
Govt bonds	 <p style="text-align: center;">-1</p>	 <p style="text-align: center;">-1</p> <p>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.</p>	
Cash		 <p style="text-align: center;">Neutral</p> <p>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.</p>	
Private markets	 <p style="text-align: center;">Neutral</p>	<p>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.</p>	

Notes: Views are from a U.S. dollar perspective, March 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



Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, March 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 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.
			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.
			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 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.
			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.
			Momentum	We keep momentum at neutral. The factor has become more exposed to cyclical, 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 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.
			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.
			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 cyclical may be rewarded amid a vaccine-led recovery.
	Fixed Income			U.S. Treasuries
			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 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.
			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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