Weekly commentary

BlackRock

March 15, 2021

A strong restart, not a recovery

- We lay out three reasons why we see a strong economic restart, rather than a normal recovery, and believe markets still underappreciate its size and speed.
- U.S. Treasury yields hit 13-month highs. We see the recent rise in real yields as justified given the growth outlook and remain tactically pro-risk.
- Investor focus is set to shift to policy meetings of major central banks for their reaction to rising yields, after passage of the $1.9 trillion U.S. fiscal package.

We see the path out of the Covid-19 shock as a "restart" – not a typical business cycle "recovery." The key reasons are the distinct nature of the shock, broad-based pent-up demand and different inflation dynamics. The passage of a $1.9 trillion fiscal package and an accelerating vaccination ramp-up in the U.S. magnify these factors, and we believe the restart will likely be stronger than markets expect.

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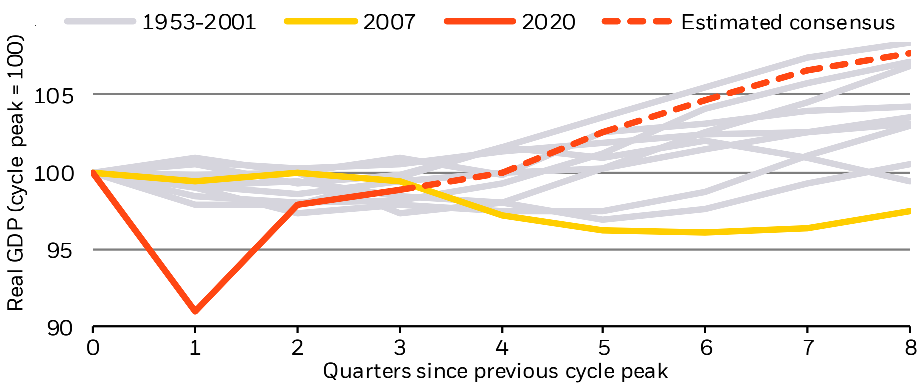
Chart of the week

U.S. real GDP after past recessions and the Covid-19 shock



Sources: BlackRock Investment Institute, with data from Refinitiv, March 2021. Notes: The solid lines show the paths of U.S. real gross domestic product (GDP) during past business cycles and so far since the Covid shock. The dotted line shows our estimate of the consensus forecast based on reports from brokers that have updated their forecasts since March 6 when U.S. Senate passed the $1.9 trillion fiscal package. The level of GDP is rebased to 100 at the peak of each past cycle, and to the fourth quarter of 2019 for the Covid shock. Peaks of past cycles are as defined by the National Bureau of Economic Research.

We see three reasons why this is an economic restart, not a recovery – a distinction that matters for markets. First, we have stressed that the Covid shock is more akin to a natural disaster: economic activity is temporarily shut down, and then rapidly comes back online. The initial lockdowns in 2020 forced a halt in economic activity, triggering a plunge in U.S. real GDP, as the chart shows. Activity quickly rebounded in the second half as restrictions eased - and is now poised to leap forward as vaccines are rolled out. The restart is about turning things back on, not about the rebuilding of confidence that is needed in a typical recovery. The restart may be much faster than in typical business cycle recoveries as a result. We believe much activity will restart on its own, and won't need policy stimulus as much as in typical recessions. We now expect U.S. real GDP to return to the pre-Covid level by mid-2021, far sooner than our expectation right after the initial shock. We see the new U.S. fiscal package bringing forward the return to pre-Covid trend growth by two to three years – further accelerating the restart.

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The second reason behind a potentially much more powerful restart: broad-based pent-up demand. Consumer spending during the Covid shock has been unusual in that spending on services dropped sharply. The stoppage in activity and spending was mainly caused by lockdowns and not income constraints, and – unusually – affected all income groups. Household finances are in much better shape today than after the financial crisis, largely thanks to ongoing fiscal policy support. We estimate excess household savings in the U.S. to be about $1.8 trillion larger than in the year before the pandemic, with lower-income households supported by fiscal stimulus. This means that pent-up demand is broad-based this time.

The third reason: Inflation dynamics look very different today. A typical recession is caused by a fall in demand. Demand catches up only slowly to supply in a normal recovery, leading to disinflationary pressure. This is less the case today, as the Covid shock was caused by a fall in both demand *and* supply. Both have to catch up, in our view. We believe many companies have used the typical recession playbook by reducing capacity and cutting costs. Can they ramp up production fast enough as demand surges? A failure to do so would lead to additional near-term price pressures. Policy support has been extraordinary. We assess that the ultimate cumulative economic loss from the shock – what matters most for markets – will be roughly a quarter of that seen after the global financial crisis in the U.S. Yet the discretionary fiscal response so far is about four times larger, and the Federal Reserve has signaled it will be less responsive to rising inflation than in the past.

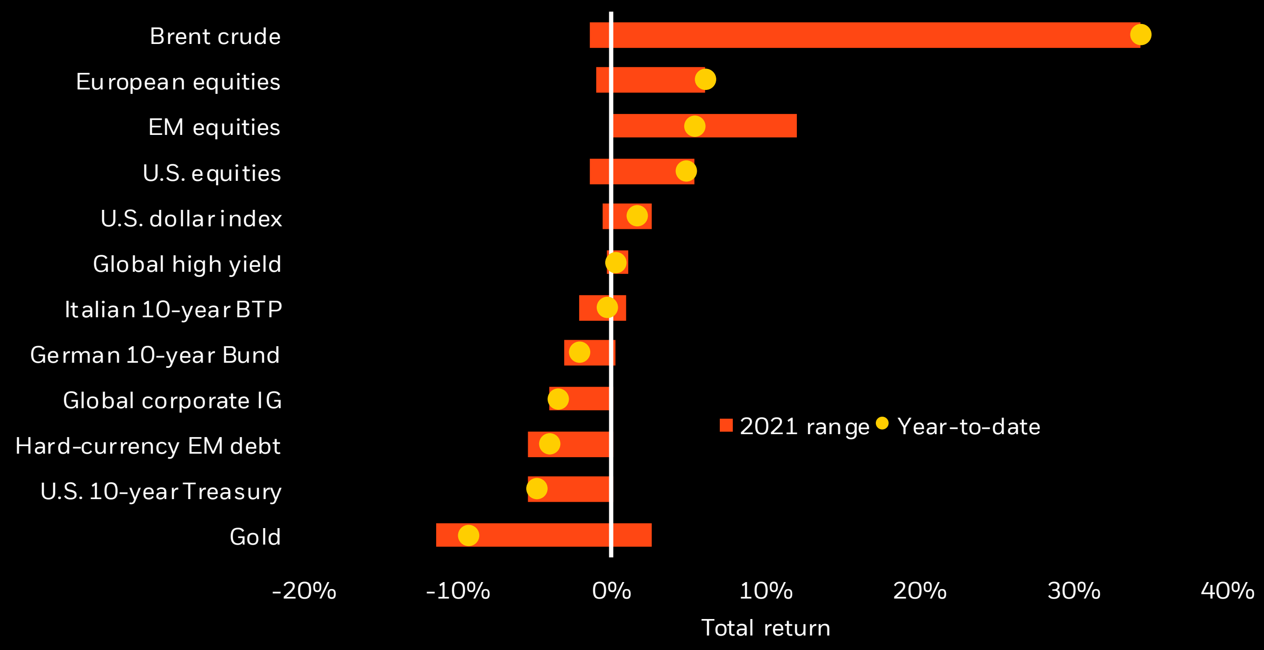
The bottom line: We see a much stronger post-Covid economic restart than what we would expect in a normal recovery. The rapid upward adjustment in U.S. Treasury yields and more muted movement in inflation-adjusted yields make sense in this respect, and are still consistent with our *New nominal* theme. The restart bolsters our pro-risk stance over the next six to 12 months, and makes us lean further into cyclical assets. We are overweight U.S. equities, and our preference for small caps extends to private equity and private credit. Elsewhere in private markets we like real assets as we see them offering some insulation against rising inflation down the road. We are also overweight emerging market (EM) equities, and see the recent selloff as an opportunity to add to this asset class. We still expect EM equities to benefit from a global cyclical upswing, supported by a stable U.S. dollar. The commodity price rally should also help resource-rich EM economies, in our view.

Market backdrop

U.S. 10-year Treasury yields hit 13-month highs; stocks slipped from record levels but were still up on the week. The $1.9 trillion fiscal package was signed into law. Inflation-adjusted yields, or real yields, have risen from record negative levels. We believe this move is justified in light of recent positive economic developments, as reflected in the OECD's recent doubling of its U.S. growth forecast for 2021. This is in line with our *new nominal* theme. We expect the *new nominal* to 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 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

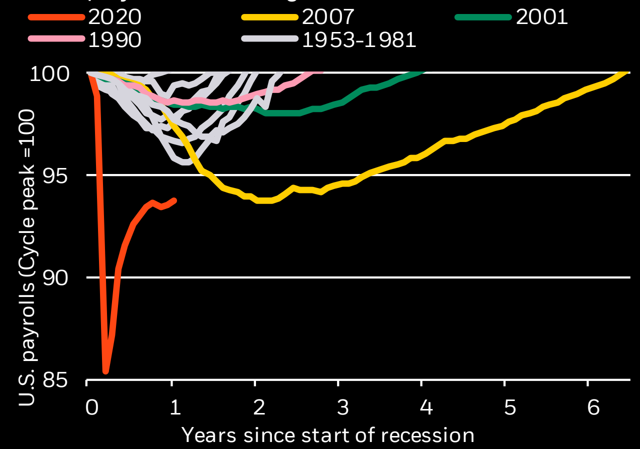
The U.S. labor market highlights why this is an activity restart, not a recovery. Employment has bounced back much more sharply than during a typical business cycle recovery. Why? Firms need to rehire faster to resume operating as halted activity comes back online and returns to pre-Covid levels.

U.S. employment plunged by around 15% almost immediately after the initial outbreak of Covid-19 prompted severe restrictions. The overall employment shortfall has already shrunk to 6% – similar to the trough of the global financial crisis. The key difference: It took two years to hit that trough *after* the 2007-08 crisis. See chart on the right.

Employment in contact-intense services – think restaurants and hotels – is still far below pre-Covid levels. Leisure and hospitality employment is still 20% below normal – the biggest gap of all industries – yet up from a trough of nearly 50% in the spring of 2020. Such services activity has a lot to gain from the release of pent-up demand in coming months. We see further rapid payroll gains through the year as the economy normalizes. For more visit our macro insights page.

Not a typical recession

U.S. employment following recessions, 1953-2020



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2021. Notes: The chart shows the level of U.S. nonfarm payrolls following business cycle peaks as defined by the National Bureau of Economic Research. Employment is indexed to equal 100 at the peak of each respective cycle.

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. The recent rise in real yields from record negative levels is justified and represents only a muted response to recent positive economic developments, in our view.
- 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. The new $1.9 trillion U.S. fiscal package poses challenge to the prevailing low interest rate environment and tests the debt tolerance of financial markets and central banks alike, in our view. We believe it also uses up limited fiscal policy space and ultimately adds to inflation pressure.
- **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 16	German ZEW Indicator of Economic Sentiment; U.S. industrial production
March 17	Federal Reserve policy meeting ends; Dutch parliament election
March 18	Bank of England policy meeting; Philly Fed Manufacturing Business Outlook Survey
March 19	Bank of Japan policy meeting ends

Market attention will be on policy meetings of a few major central banks this week – especially on comments on how central banks will respond to higher bond yields, and loose financial conditions targets they plan to set. The Fed will release the updated Summary of Economic Projections that are expected to show more optimism. We expect the guidance on rates and asset purchases to stay unchanged.

Directional views

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

Change in view

Previous New

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.
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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