Weekly commentary

BlackRock

Nov. 16, 2020

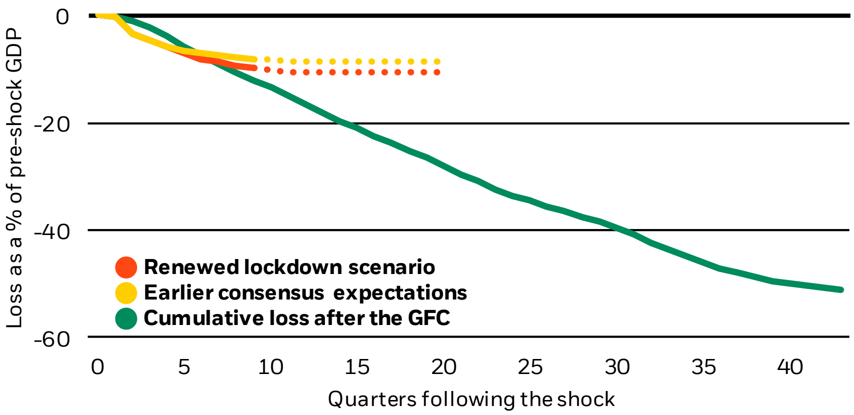
Vaccines shape 2021 outlook

- Positive Covid vaccine developments give us greater confidence in the activity restart, and may make it easier for policy support to bridge the income gap.
- The vaccine news sparked a sharp rotation into value and small-cap stocks that fizzled later in the week when near-term virus concerns returned to the fore.
- China's industrial output data this week will likely confirm the ongoing recovery while U.S. data may not yet reflect the recent worsening in virus dynamics.

Positive news on Covid vaccines gives us greater confidence that the economic restart can re-accelerate in 2021 – and that the cumulative activity loss from the virus shock will ultimately be a fraction of that seen after the global financial crisis (GFC). We prefer to look through any market volatility generated by the virus resurgence and renewed restrictions over the challenging months ahead.

Chart of the week

U.S. GDP shortfall from the GFC vs. estimated loss from the Covid shock



Sources: BlackRock Investment Institute, with data from Reuters News, November 2020. Notes: The green line shows the cumulative sum of the difference between actual U.S. GDP and where it would have been had it grown at its pre-GFC trend level (3.4% a year in nominal terms) from 2007 onwards. The solid yellow line shows the total shortfall of U.S. GDP over two years from the last quarter of 2019, based on the median expectation from a Reuters poll of economists published on Sept. 25, 2020. The solid orange line shows our estimate for a hypothetical scenario of renewed tightening/lockdown measures. We assume trend growth after the two years, shown as the dotted lines. For illustrative purposes only. There is no guarantee that any forecasts made will come to pass. The hypothetical scenario is subject to significant limitations as the pandemic is evolving and we are still trying to understand the potential for more extensive activity shutdowns

Traditional business cycle analysis doesn't apply to the Covid shock, in our view. We see the latter as more akin to the shock of a natural disaster: With the vaccine news, we have even greater visibility on how the cumulative activity loss will likely be limited – just a fraction of that seen after the GFC in our estimate - even as we expect a renewed surge in infections and resulting restrictions to disrupt the restart in the near term. See the chart above. We are still months away from any vaccine being widely available. But the game changer is that we now know we are building a bridge to somewhere, providing more clarity for governments and companies about getting to the post-Covid stage. That will make it easier to absorb any near-term disappointments and have greater confidence in the restart plan. It should also help limit any economic scarring and justify deploying further policy support. Yet risks of retrenching fiscal policy too soon, especially in the U.S., look to be significant. Still, we see the vaccine development providing a constructive backdrop for risk assets as we approach 2021.

Jean Boivin
Head – BlackRock Investment Institute

Mike Pyle
Global Chief Investment Strategist – BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute

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BlackRock **Investment** Institute

BlackRock's portfolio managers and senior executives gathered virtually last week at our 2021 Outlook Forum to discuss what we see as a new investment order. The pandemic has accelerated transformations in our economies and societies across four dimensions – sustainability, inequality, geopolitics and the policy revolution. A tectonic shift toward sustainability was already under way, and the pandemic shone a spotlight on some underappreciated environmental, social and governance (ESG) factors such as employee safety and supply chain integrity.

The pandemic is also accelerating geopolitical trends that were already in motion – such as the shift toward a bipolar U.S.-China world order and a remapping of global supply chains. A simple way to think about it: The global economy is recalibrating from a single-minded focus on cost efficiency and short-term profitability to a system that puts greater weight on long-term resilience. Reduced global specialization could result in higher production costs, in our view.

The inflation outlook was at the center of our debates. The pandemic has spurred new structural trends such as a policy revolution that sees greater coordination between fiscal and monetary policy. Central banks are showing an increased tolerance for inflation overshoots after persistent inflation undershoots, and the fiscal-monetary coordination is leading to political pressure to keep interest rates low even amid rising price pressure. Together with rising production costs stemming from the remapping of global supply chains and more focus on sustainability, this points to a higher inflation regime over the medium term. This is a shift that markets are not prepared for, even though in the near term corporates' cost-cutting effort may help mitigate some price pressure.

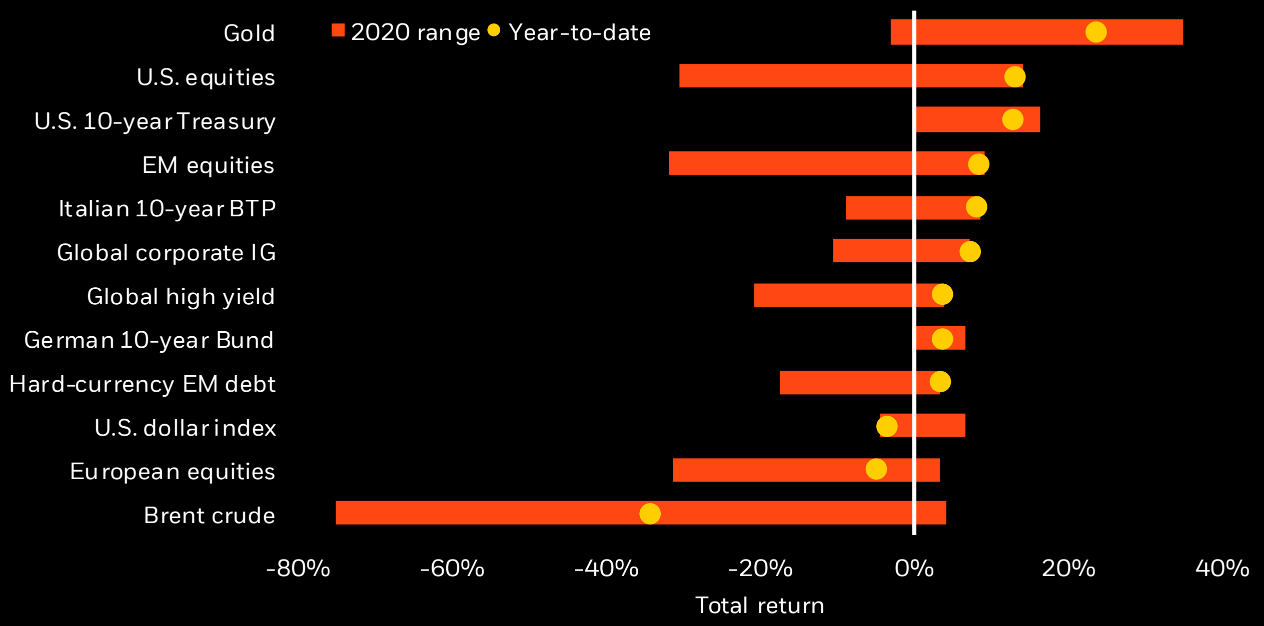
Investors need to adapt their portfolios to these accelerated trends, including higher inflation in the medium term. These views reinforce our strategic underweight in nominal bonds and preference for inflation-linked debt, as well as our belief that allocations to Asia's growth engine and private markets will be crucial for delivering real diversification in the post-Covid world. We also favor sustainable assets as we see sustainability becoming the fundamental source of portfolio resilience. Even with a vaccine on the way there are major sectoral implications as the Covid shock creates structural winners and losers. We see big tech companies likely maintaining their high margins under a divided U.S. government and airlines among the potential losers as business travel recovers only slowly. Stay tuned for our 2021 Global outlook.

Market backdrop

The positive vaccine news triggered a sharp rotation into value and small-cap equities that fizzled later in the week when near-term virus concerns returned to the fore. Effective vaccines would allow a broader opening-up of activity sooner and reduce the risk of long-term scarring, in our view. Yet we do see potential for near-term disruption to the economic restart caused by the ongoing virus resurgence and government restrictions.

Assets in review

Selected asset performance, 2020 year-to-date and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2020. 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: spot gold, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

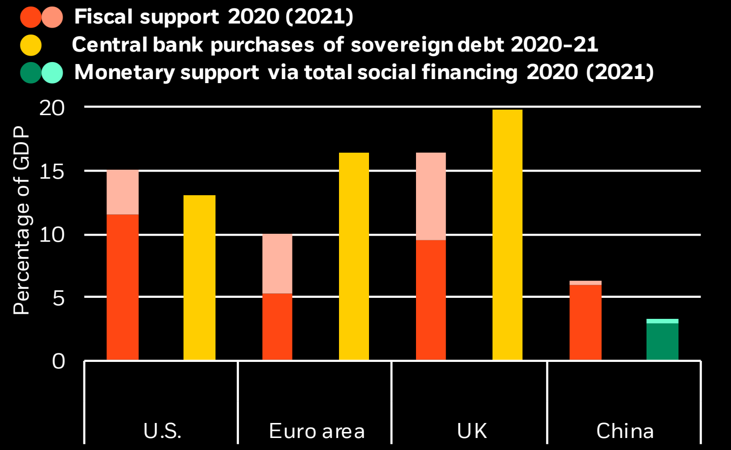
Macro insights

The timing of widely available Covid-19 vaccines will be a key driver of the restart – particularly as the prospects for U.S. fiscal stimulus appear more limited. Fiscal policy must keep playing a key role to sustain households and businesses through the income shock, as monetary policy alone cannot generate growth. Yet the encouraging vaccine news strengthens our base case of a 2021 cyclical recovery – and may reduce the amount of fiscal support needed. This would also lessen the risk of long-term economic scarring as hard-hit industries swing back and hiring picks up. Investors and policymakers now know there is a bridge to *somewhere*. Also, there is no talk of fiscal austerity – a stark difference from after the GFC.

Yet the latest Covid surge is likely to plunge the euro area economy back into contraction in the fourth quarter, with the U.S. not far behind. This will increase cumulative economic losses suffered compared to pre-pandemic levels – but we still believe the ultimate shortfall will be a fraction of what it was after the GFC.

The importance of policy support

Global monetary and fiscal policy, 2020-2021



Sources: BlackRock Investment Institute with data from Haver Analytics, November 2020. Notes: The orange bars show estimates of discretionary fiscal measures in 2020 to offset the Covid-19 shock. The light orange bars show fiscal measures for 2021, based on estimates from brokers. The green bars show the estimated impulse of monetary growth in China, measured as total social financing growth minus local government debt purchases. There is no guarantee forward looking estimates will come to pass.

Investment themes

1 Activity restart

- Positive Covid vaccine developments reinforce our expectation that the economic restart can gather steam again in 2021, even as the virus resurgence and renewed tighter restrictions look set to disrupt activity in the near term.
- The sharp rise in Covid hospitalization rates in Europe has led to the re-imposition of national lockdowns – albeit not as stringent as in the spring. New fatalities in Europe are on the rise. The U.S. has reported record hospitalizations, along with rapidly growing case numbers and rising fatalities.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-Covid world could be painful, especially for contact-intensive sectors if mobility is curtailed for an extended period of time.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield on both a strategic and tactical horizon. We are tactically overweight broad EM, Asia ex-Japan equities and the size style factor in the U.S., and have closed our overweight in European equities.

2 Policy revolution

- The joint fiscal-monetary coordination in response to the Covid-19 shock is nothing short of a policy revolution. The Federal Reserve is leading major central banks in evolving policy frameworks to explicitly aim to let inflation overshoot targets – a desirable move in the current environment but the lack of proper guardrails raise concerns.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows. Policy support – both fiscal and monetary – is still a crucial bridge before the rollout of effective vaccines.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus, as a Biden administration could be constrained in implementing its key policy plans including large fiscal spending. The European Central Bank has committed to take new action in its December policy meeting.
- Europe's historic recovery fund will introduce mutualized debt and create jointly issued European bonds that can compete with other perceived safe-haven assets. It still needs approvals by the European and national parliaments.
- The blurring of monetary and fiscal policy means that it is crucial to have proper guardrails around policy coordination. In their absence we see a risk that major central banks could lose grip of inflation expectations relative to their target levels. Combined with other structural changes accelerated by Covid such as deglobalization, it could lead to a higher inflation regime in the next five years.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on both strategic and tactical horizons. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions in technology stocks.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We see countries, sectors and companies making a comeback as potential diversifiers in a fragmented world, offering resilience to these trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. We believe investors should consider alternative return sources that can provide potential diversification.
- A focus on sustainability makes portfolios more resilient, in our view. We believe the adoption of sustainable investing is a tectonic shift carrying a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer sustainable assets, private markets and deliberate country diversification on a strategic basis. We are overweight the quality factor on a tactical horizon, favor assets with policy backstops.

Week ahead

Nov. 16	China industrial output, retail sales	**Nov. 19**	Federal Reserve Bank of Philadelphia November Manufacturing Business Outlook Survey
Nov. 17	U.S. industrial production	**Nov. 20**	Japan Jibun Bank Flash composite purchasing managers' index (PMI)

Manufacturing data this week will be in focus. China's industrial output likely grew for the seventh consecutive month in October, according to a Reuters poll, as the country's economic recovery is well underway. U.S. manufacturing data may not reflect the impact from the virus resurgence yet, but we see downside risks to the activity restart in coming months if lockdown measures tighten.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2020

Asset	Strategic view	Tactical view	
Equities	Neutral	Neutral	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall. We like the quality factor for its resilience and favor EM especially Asia ex-Japan stocks.
Credit	Neutral	+1	We are neutral on credit on a strategic basis because we see investment grade (IG) spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, we strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
Govt bonds	-1	Neutral	The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. Such low rates reduce the asset class's ability to act as ballast against equity market selloffs. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation suppresses yields.
Cash		Neutral	We are neutral on cash. Holding some cash makes sense, in our view, as a buffer against supply shocks that could drive both stocks and bonds lower.
Private markets	Neutral		Non-traditional return streams, including private credit, have the potential to add value and diversification. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures but valuations and inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, November 2020. 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, November 2020

	Asset	Underweight	Overweight	
Equities	United States			We are neutral on U.S. equities. Risk of fading fiscal stimulus and an extended epidemic weigh on markets. Renewed U.S.-China tensions and a divisive election also weigh.
	Euro area			We are neutral on European equities. Covid cases have surged just as the economic restart appears to be losing steam. Renewed restrictions are weighing on activity.
	Japan	■		We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration.
	Emerging markets		■	We are overweight broad EM equities as more stable foreign and trade policy under a Biden administration could benefit EM assets.
	Asia ex-Japan		■	We are overweight Asia ex-Japan equities. China and a number of other Asian countries have done a better job of containing the virus – and are further ahead on the road to economic recovery.
	Momentum			We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold.
	Value			We are neutral on value. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance.
	Minimum volatility	■		We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
	Quality		■	We are overweight quality. We see it as resilient against a range of outcomes in the pandemic and economy.
	Size		■	We are overweight size. We expect small- and mid-cap U.S. companies to likely benefit from a cyclical upswing over the next 6-12 months with positive Covid vaccine development, even as the outlook for large fiscal stimulus dims.
Fixed Income	U.S. Treasuries	■		We downgrade U.S. Treasuries to underweight. The potential for fiscal spending – particularly in a Democratic sweep election outcome – could spur higher yields and a steeper yield curve.
	Treasury Inflation-Protected Securities		■	We upgrade TIPS to overweight. We see potential for higher inflation expectations to get increasingly priced in on the back of loose monetary policy, greater fiscal stimulus and increasing production costs.
	German bunds			We upgrade bunds to neutral. 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 overweight euro area peripheral government bonds despite recent outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions.
	Global investment grade			We hold investment grade credit at neutral. We see little room for further yield spread compression. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
	Global high yield		■■	We keep our strong overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency	■		We are underweight hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced.
	Emerging market – local currency	■		We are still underweight local-currency EM debt. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
	Asia fixed income		■	We are overweight Asia fixed income. China and other Asian countries have done better in containing the virus and are further ahead on economic recovery.

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BlackRock Investment Institute

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