BlackRock.

Portfolio perspectives
November 2021

What could go wrong?

Updated capital market assumptions and stress testing the themes that drive our strategic asset views

BlackRock
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Summary

- Our strategic asset views – a broad preference for equities over nominal government bonds and credit – remain stable through the noisy economic restart. Our views are underpinned by three important themes: the *new nominal*, or the muted central bank policy response to higher inflation, China as a distinct asset class and global growth engine and the *journey to net zero*. These themes have provided an anchor amid the confusion around competing market narratives that have spurred short-term volatility, particularly in short-term interest rate markets, in recent months.
- Our key themes and the asset recommendations they imply – an overweight in developed market (DM) equities, a high-conviction underweight in DM nominal government bonds and a strong overweight in inflation-linked bonds - have been playing out for the last 18 months. DM equities and inflation-linked bonds have done well while nominal government bonds' performance has been poor. It is appropriate to question whether these views still hold after the strong performance. We believe they have more room to run.
- We anticipate policy interest rates in the U.S. to gradually start to rise in 2022, keeping the outlook challenging for developed market (DM) nominal government bonds. A shift to higher rates may also seem like a challenge for risk assets yet we believe we are in a different regime that suggests this may not be the case. We see interest rates in this cycle to cumulatively rise less than in prior hiking cycles. A subdued path of rate rises alongside relatively healthy growth, higher medium-term inflation and low real yields still supports risk assets.
- Uncertainty around inflation and the path ahead for interest rates, plus concern about China's growth slowdown, have caught the market's attention. The performance of our views and recent market dynamics lead us to check the ongoing validity of our themes. Here we stress test our *new nominal* and *China stands out* themes to gauge just how different the outlook needs to be from our base case to shift our asset preferences. The answer: Materially.
- We believe we would need a scenario of significantly higher short-term rates, potentially triggered by the Federal Reserve abandoning its new policy framework or materially reinterpreting elements of its new framework, to call time on our new nominal theme. On China, a significant derailing of the economy – such as a long-lasting growth shock akin to Japan in the 1990s – would impact all our asset views.
- We find both these alternative scenarios unlikely. We see yields climbing gradually higher but less so than they would have in the past at similar levels of growth and inflation. We see inflation settling at a higher level than pre-Covid but below current spot levels as the unusual restart-driven supply shocks ease. We maintain a high conviction in our new nominal theme and see longer-term challenges for nominal developed market (DM) government bonds.
- On China, we believe global investors' starting point of relatively low allocations to Chinese assets suggest they are already positioned for a sustained Chinese slowdown or see China as un-investible. We see this year's regulatory clampdown on certain industries that has unnerved global investors as in line with a long-term hawkish macro policy stance as the country prioritizes quality – over quantity – of growth. This process is not a straight line but for those investors eligible to include China in portfolios, we see adequate compensation for risks associated with this shift.
- Bottom-line: We see the themes underpinning our capital market assumptions persisting. We see interest rates going up by less than prior hiking cycles. We see interest rates rising, yet do not see DM central banks tightening policies to the extent they stymie growth and tame inflation – a backdrop that favors DM equities and inflation-linked bonds while clouding the outlook for DM nominal government bonds. On China, we see a strategic case for higher allocations to Chinese assets relative to a starting point of very low allocations global investors hold today.

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Our latest strategic views

Our strategic tilts – a broad preference for equities over credit and inflation-linked bonds over nominal government bonds – have remained stable amid the unusual economic restart. Strong corporate earnings and low real rates have supported equities that remain close to record highs. Yet recent months have been marked by significant volatility - particularly around the interest rate outlook sparked by market uncertainty around central banks' reaction function amid rising inflation, but also around China's slowing growth and supply shocks that have seen energy prices soar globally.

Our core investment themes have helped us to cut through the confusion of competing market narratives. We see the central bank policy and nominal yield response to higher inflation to be the most muted it has been in decades. In our view, the U.S. Federal Reserve would already be raising interest rates at current levels of growth and inflation under its old policy framework, highlighting how their reaction function has changed significantly. In our view, key to the path for U.S. interest rates will be how the Fed interprets its full employment mandate. We see interest rates climbing gradually yet real yields staying relatively low – a positive for risk assets and a negative for nominal government bonds.

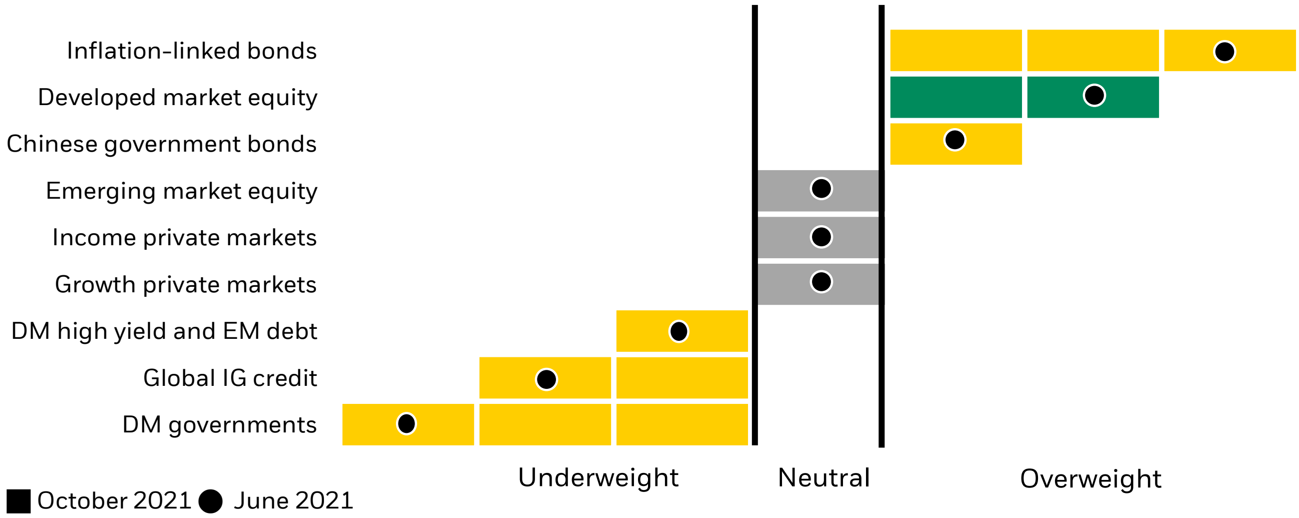
We push back against the notion that higher spot inflation indicates a repeat of 1970s-style stagflation. The growth outlook remains robust, in our view. We believe the unusual supply shocks tied to the restart are driving higher inflation. We expect these imbalances to resolve over the next year yet see some persistence in price pressures – a reflection of central banks' increased tolerance of inflation overshoots. We estimate U.S. inflation averaging just under 3% over a five- to 10-year horizon. Such a view is already embedded in our CMAs. The expected shift to a higher medium-term inflation regime supports the strong overweight to inflation-linked bonds as shown in the chart below. Our expected returns for inflation-linked bonds are much higher than nominal government bonds due to our views of higher medium-term inflation and the lower valuation drag from yields grinding higher. We see low-yielding nominal bonds as poor portfolio ballasts.

We remain overweight Chinese assets. We see Chinese assets as an important source of returns for most globally diversified portfolios. China portfolio allocations have come under scrutiny amid a regulatory clampdown. Our base case already assumes policymakers tighten control of the economy over time as China's leadership balances social and economic objectives. We assume materially higher uncertainty and higher risk premia for China compared to developed markets in our CMAs. We recognize the path won't always be smooth but believe investors are being rewarded for the inherent risks. Current allocation to Chinese assets in global portfolios, on average, point to an overly negative economic outlook in coming years, in our view.

The new nominal, alongside our two other investment themes - *China stands out* and the *journey to net zero* - continue to underpin our views. We believe part of the volatility we have seen over the past quarter is a reminder of the unusually wide range of economic outcomes that potentially lie beyond the restart. It is prudent amid such a macro backdrop to continuously stress test asset preferences should our investment themes unfold less benignly that we currently expect. In this paper, we dig into alternative scenarios involving a spike in nominal yields and a gloomy outlook for China. Over the summer, a supply crunch sparked intense volatility across the energy sector, providing a glimpse of what a disorderly climate transition might look like. Our climate-aware CMAs are predicated on a smooth transition to net-zero world by 2050, which is mildly inflationary and baked into our strategic views. The implications of a disorderly transition present a complex challenge – one we will address in a more detailed research in coming months.

Still prefer equities over credit and government bonds

Hypothetical U.S. dollar 10-year strategic allocation vs. our equilibrium view, November 2021



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute, November 2021. Data as of 31 October 2021. The chart shows our asset views on a 10-year view from an unconstrained U.S. dollar perspective against a long-term equilibrium allocation. Global government bonds and EM equity allocations include respective China assets. Income private markets include infrastructure debt, direct lending, real estate mezzanine debt and US core real estate. Growth private markets include global private equity buyouts and infrastructure equity. The allocation shown is hypothetical and does not represent a real portfolio. It is intended for information purposes only and does not constitute investment advice

What rate path cuts our equity view?

The new nominal remains core to our strategic views. The Federal Reserve and European Central Bank have adopted new policy frameworks that explicitly allow for greater inflation tolerance than in the past. We believe this means that interest rates and nominal yields will stay lower for longer. It also points to higher inflation over the medium-term – something that is already baked into our views. In this environment of low real rates and moderately higher inflation, we prefer equities over nominal bonds.

In recent months, markets have challenged central banks' new frameworks by testing their resolve to not lean against the higher spot inflation fuelled by the restart. Surging spot inflation pulled forward market expectations of the first policy rate hikes – or the lift-off - across central banks, notably the Fed. Yet we believe what matters is not the timing of the first hike: a somewhat earlier lift-off is less important than the cumulative increase in rates over the hiking cycle. To really challenge our new nominal would require a steeper policy rate path, more akin to past hiking cycles.

We test an alternative scenario of policy rates rising sooner and further to try to estimate just how much higher the path needs to be tip the balance against equities. Our valuation models suggest that short-term cash rates would need to be 80 basis points higher than our current estimates to turn us neutral on equities. The chart on the left below shows 3-month U.S. cash rates with their expected path in our base case and alternative scenario. The alternative scenario would require the Fed react more like it has in the past – and abruptly end the joint monetary and fiscal policy revolution that has brought about massive debt levels and a higher tolerance for inflation.

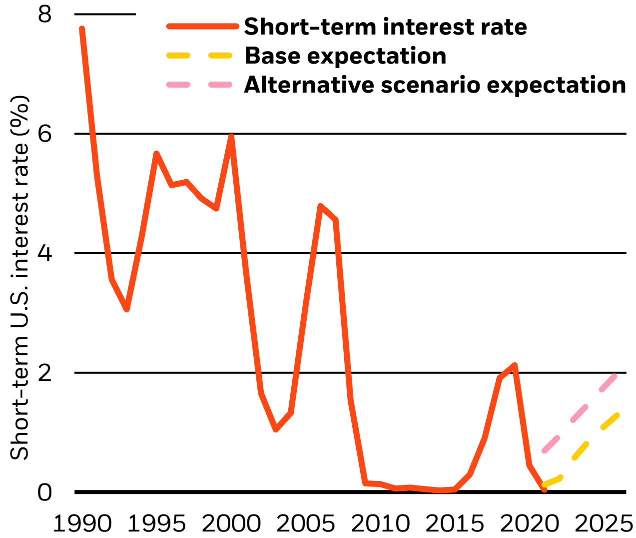
A sharp rise in the path of short rates would hit equity valuations. Our scenario would see our U.S. equity expected returns down around 2%, with a greater impact felt in rate sensitive sectors such as tech that typically have a low equity risk premium (ERP) – our preferred valuation gauge that accounts for earnings growth as well as the rate outlook. Less rate sensitive sectors such as energy that have higher ERPs would fare better. In the alternative scenario, our estimate of the 10-year U.S. Treasury yield remains at 2.5% despite higher cash rates. Why? Central bank tightening drives medium term inflation expectations lower, pushing down our break-even inflation estimates relative to current expectations.

Potential portfolio implication: The impact on our strategic asset allocation (SAA) preferences is shown on the right chart. Fixed income assets perceived to be higher quality, such as DM government bonds and investment grade credit, become relatively more attractive, as yield curves flatten more than our base expectations. Yet even in this scenario they remain an underweight – just less so. Inflation-linked bonds would be less of an overweight but still preferable to nominal bonds, given the latter's low returns and reduced ballast role.

Current investment stance: We see the kind of spike higher in short-term rates described above as unlikely. Markets are pricing in short-term rates rising to 1.9% by the end of the decade, according to data from Bloomberg as of November 2021. Our alternative scenario is materially above that at 2.4% by end 2030. We maintain our conviction in our new nominal theme that supports our preference for equities.

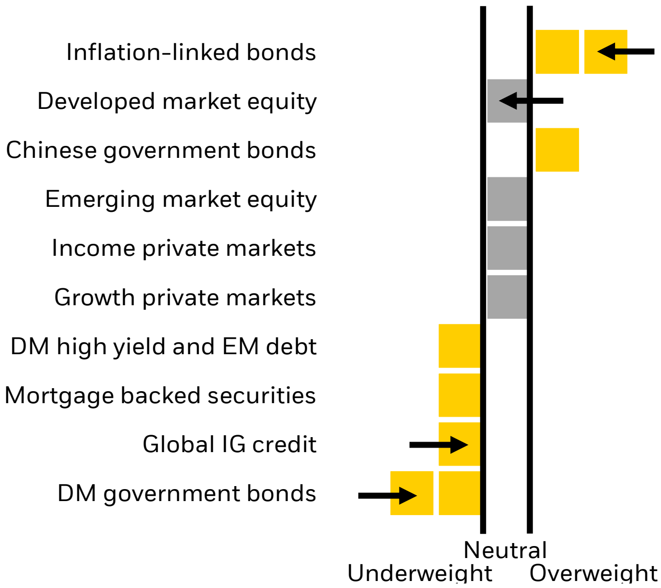
A yield spike

Short-term U.S. rates and path expectations, Nov. 2021



How our views would shift

Potential impact on asset views if short-term rates surge



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What China scenario hurts our views?

We discussed our strategic preference for Chinese assets in detail in our May 2021 paper *The role of Chinese assets*. Since then we have had more evidence that the long-term direction of travel for policy in China is likely to be more state intervention. China's regulatory clampdown on certain industries this year that has weighed on growth and rattled investors in this context is one stark example. In our view, policymakers' goal with these actions - alongside a relatively hawkish monetary and fiscal policy stance - is for a more equitable economy and higher quality growth, instead of mere quantity. Such a significant shift comes with clear risks to growth. Yet we believe global investors' low average allocations to China today suggest they hold a particularly pessimistic view on the outlook, prompting a stress test of our views.

In our stress test, we assume China derails economically in the form of a sustained, sharp slowdown. We looked to the 2015-16 China growth shock and market reaction as an indication of what such a scenario would look like. Back then, an equity market shock was accompanied by yuan devaluation and widespread fears of a significant growth slowdown. In our alternative scenario we assume such a backdrop persisting over a longer time period – think a Japan post-1990 scenario with an aging population and anaemic growth, rather than a 2008-style crisis. The left chart below shows our expected returns for the MSCI China equity index in the alternative scenario compared to our current expectations.

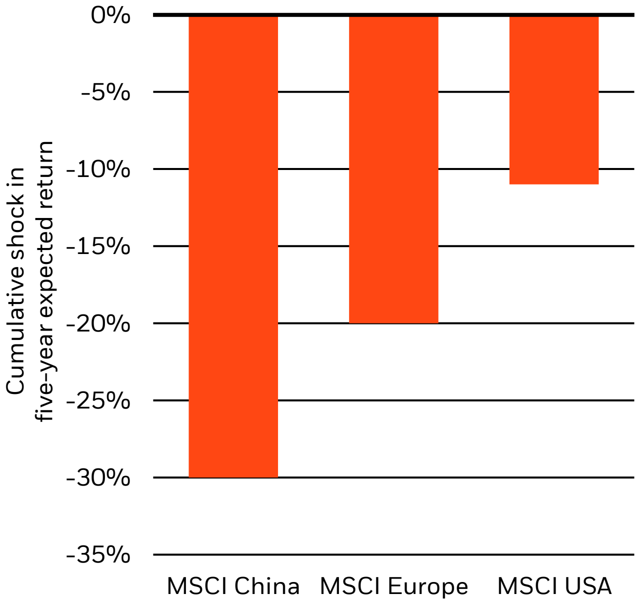
We believe such a backdrop would ultimately bring China bond yields lower - narrowing the yield gap with the U.S. and Europe. It would also drive down Chinese equity valuations as investors demand higher equity risk premium to compensate for greater uncertainty amid slower economic growth that erodes earnings growth. The effects would not be confined to China - a slowdown in China growth would be a drag on global equities and push global bond yields lower, in our view.

Potential portfolio implication: The chart on the right shows the potential impact on our asset views. The biggest allocation impact would be a reduction in global equities given the serious, negative implications on global growth and corporate earnings prospects from sharply slower growth in China. The increase in Chinese government bonds appears counterintuitive yet falling yields in an adverse economic outcome would boost the asset class' expected returns. Our scenario is not one in which China becomes non-investible – it is one where growth slows. This would dent the risk assets such as equities globally and brighten the appeal of all government bonds rather than just those issued by China.

Current investment stance: We believe investors' allocations to Chinese assets today seems like they are already positioned for a scenario where China's economy derails as described above. The hawkish policy stance and impact of tighter regulations has already spurred a significant underperformance of Chinese and equities and credit markets in 2021. Valuations for Chinese equities have diverged sharply from the U.S. Our estimate of the equity risk premium – our preferred valuation gauge that takes into account prevailing interest rates – stands at 8% for China compared to 4.3% for the U.S, as of end-October. A higher ERP for Chinese equities is warranted in our view given uncertainties, yet we see current valuations painting an overly pessimistic picture.

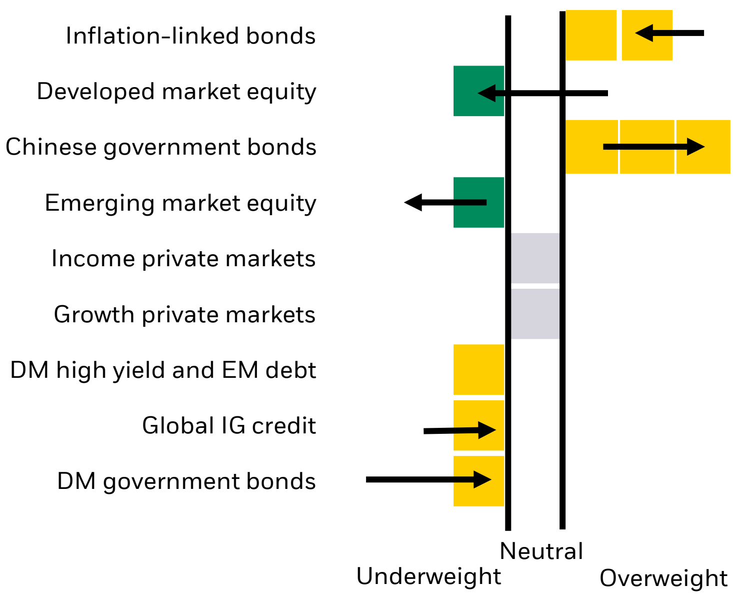
Assessing the downside

Estimated return impact from persistent China slowdown



How our views would shift

Potential impact on SAA in alternative China scenario



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Appendix

Index proxies

Asset	Index
Equities	MSCI Developed - US Gross TR Index
	MSCI Developed - United Kingdom
	MSCI EMU Index
	MSCI Developed Europe ex UK Gross TR Ind
	MSCI Developed - Japan Gross TR Index -
	MSCI Daily TR Gross Developed Pacific Ex
	MSCI China A Inclusion NET Index
	MSCI Emerging - China in CNY
	MSCI Emerging Markets ex China (Net)
Fixed Income (Sovereign bonds and investment grade)	Bloomberg Barclays U.S. Treasury 1-10 Yr Index
	Bloomberg Barclays U.S. Treasury 10+ Yr Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Euro Treasury 1-15 Year Index
	Bloomberg Barclays Sterling Aggregate Gilts (1-10)
	Bloomberg Barclays Asian Pacific Japan Treasury
	Bloomberg Barclays China Treasury + Policy Bank Total Return Index
	Bloomberg Barclays US Government Inflation-Linked Bond 1-10yr Index
	Bloomberg Barclays U.S. Tips Index 10Yr Plus - USD GROSS TR
	Bloomberg Barclays Euro Government Inflation-Linked 1-10 Years Index
	Bloomberg Barclays Inflation Linked Eurozone Inflation 10+Y
	Bloomberg Barclays MBS Index
	Bloomberg Barclays U.S. Credit Index
	FTSE Actuaries UK Index-Linked Gilts up to 5 Years Index
	FTSE Actuaries UK Index-Linked Gilts over 5 Years Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	Bloomberg Barclays Sterling Aggregate Corporate Bond Index
Fixed income (High yield)	Bloomberg Barclays U.S. Credit Index
	Bloomberg Barclays Euro Aggregate Corporate Index
	JP Morgan EMBI Global Diversified Index
	JP Morgan GBI-EM Global Diversified Index
Income and growth private markets*	U.S. private equity
	Global direct lending
	Global Infrastructure equity
	U.S. core real estate
	Real estate mezzanine debt
	Hedge funds (global)
	U.S. infrastructure debt
	Developed markets infrastructure debt

* We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class.

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