

Weekly commentary

June 1, 2020



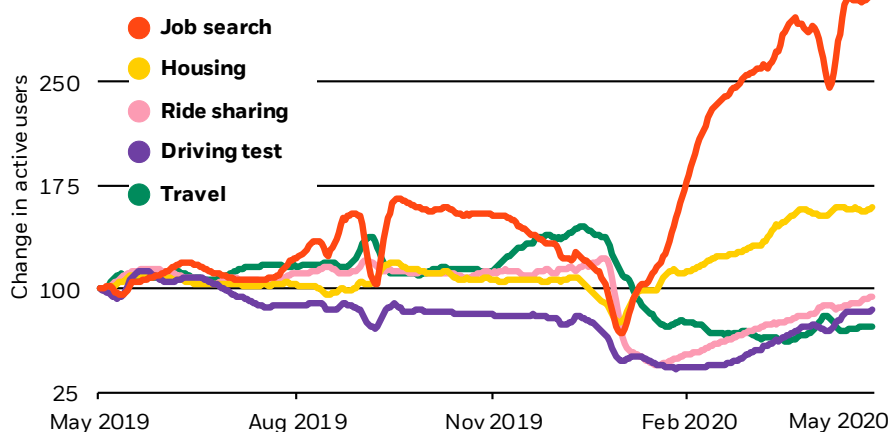
China emerges from virus lockdowns

- China’s economy is restarting after emerging from lockdown, likely benefiting countries and assets exposed to its growth.
- The key to the policy response has shifted to ensuring successful execution and avoiding policy fatigue before the shock passes.
- Markets will watch the European Central Bank’s policy meeting for if it will increase the size of its pandemic emergency purchase program.

China’s economy – the first to enter lockdowns and the first to emerge from them – is restarting. We see the economy likely returning to near-trend growth by late 2020, supported by policy stimulus, especially on the monetary front. China’s economic restart – along with that in East Asia more broadly – underpins our modest tactical overweight in equities and credit in Asia outside Japan.

Chart of the week

Change in leading Chinese mobile apps users, May 2019 – May 2020



Sources: BlackRock Investment Institute and BlackRock’s Systematic Active Equity (SAE) team, with data from Aurora Mobile Limited, May 2020. Notes: Each line represents the change in the weekly average of daily active users of the mobile app with the highest penetration in each market in China, rebased to 100 on May 31, 2019. The apps are Ctrip for travel, Didi Chuxing for ride-sharing, Anjuke for housing, Jiakaobaodian for driving test practice, and Boss Zhipin for job search, based on SAE research.

The unprecedented nature of the coronavirus shock makes alternative data sources more important than ever to sniff out emerging economic trends that official data may be slow to capture. BlackRock’s Systematic Active Equity (SAE) team has been using big data analysis to track the economic recovery as well as policy signals. One such example is the daily usage of Chinese mobile apps that help facilitate activities such as ride sharing, job hunting and travel bookings. These metrics have rebounded after a sharp dip in late January when lockdown measures were imposed, yet mostly remain below pre-virus levels. See the chart above. Job and housing related app usage is the exception, reflecting a spike in unemployment and pent-up demand. Such trends may preview how the recovery could play out across sectors elsewhere, although China’s experience is no clear roadmap for developed economies that were hit by the virus later and have undertaken different public health approaches.



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We see the Chinese government’s recent economic policy actions as lending further support for the restart. The Chinese government unveiled some notable policy moves at the recent annual session of the National People’s Congress, the country’s top legislature. A shift in tone on monetary policy – potentially opening the spigot for increased credit growth – is particularly significant. It adds to fiscal stimulus that so far hasn’t been overwhelming, in our view. The government has moved away from setting an explicit 2020 growth target for gross domestic product (GDP), and is focusing on social issues including job creation as part of an ongoing effort to balance economic growth with financial and social stability. Already, industrial profits and revenues for April recovered sharply on an annual and sequential basis. Together with other positive survey data, this points to a potential strong upturn in economic growth in the second quarter.

One risk to China’s restart – and the world’s – is further deterioration in U.S.-China relations, after the pandemic has brought them to their lowest point in decades. Whatever goodwill came from the Phase 1 trade agreement has now been lost amid mutual recriminations, China’s steps to enhance its global position and a bipartisan re-assessment of the China relationship, made more pointed by the U.S. election year. Potential flashpoints include trade commitments, technology and investment restrictions and policies toward Hong Kong. A decoupling between the two countries in sensitive industries such as technology is accelerating.

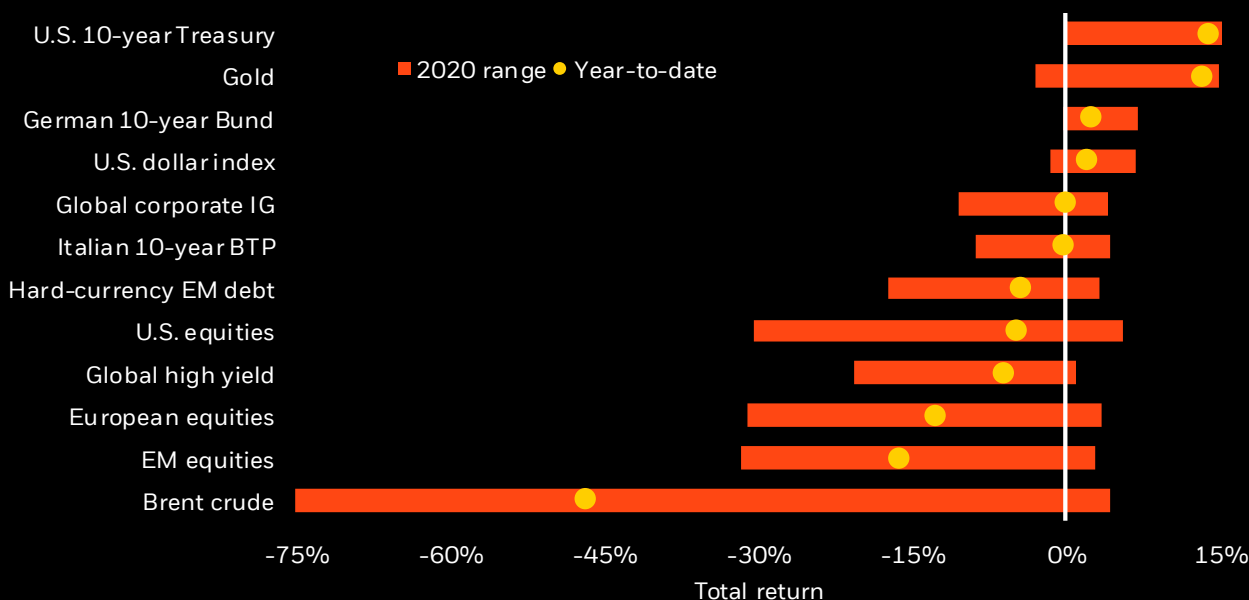
The global economy is likely to have two engines of growth in the years ahead: The U.S. and Asia, centered in China. Strategic portfolios will want allocations to both regions. The U.S.-China decoupling likely only adds to this investment case – with exposures across the two regions adding diversification. For example, government bonds from the region offer higher expected returns just as developed market government bond yields have hit record lows. This is true over the tactical horizon as well, and we are overweight Asia ex-Japan equities and credit. Many Asian countries have demonstrated their ability to curb the virus spread so far, and look poised for a strong economic restart. We are watching U.S.-China tensions closely as a key risk to this view.

Market backdrop

Measures to contain the virus are gradually being eased in many developed economies. May’s data suggested the worst of the contraction may be behind us, but we see a bumpy restart in coming months. The big question remains: how successful policy execution will be in bridging cash flow constraints and preventing permanent damages to the economy – and what the risk is of policy fatigue in coming months. Markets became wary of rising U.S. China tensions.

Assets in review

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



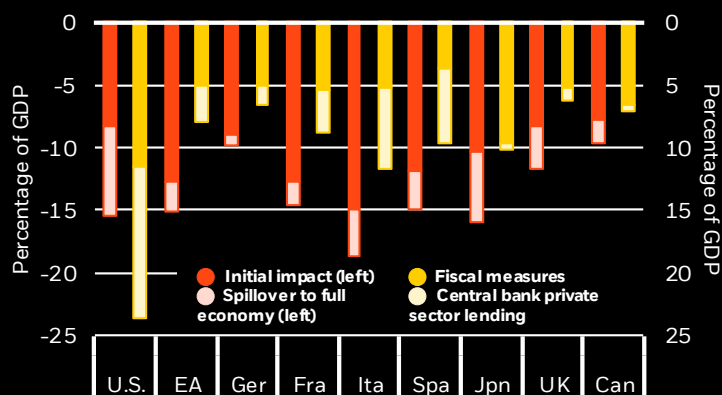
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent 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 Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DX), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

The plunge in activity triggered by the coronavirus has led to an unprecedented policy response. But will it be enough to fill the gap left by the drop in demand, incomes and cashflows? Our bottom line: policy execution is crucial. Major economies may still struggle to bridge the gap entirely – even with policy programs of a size not seen since World War II. The chart compares income loss to the size of the policy responses announced. In the U.S., this fiscal response more than covers the initial impact. But once we factor in the spillover to other sectors in the economy the fiscal policy response falls short globally. The situation improves when fiscal policies are combined with monetary policies. This is especially striking in the U.S., where the monetary and fiscal response has been coordinated to facilitate direct financing to the private sector by the Federal Reserve, including corporate lending and corporate debt purchases (light yellow bars). This direct lending is on a par with the fiscal boost, and based on projections should exceed the hit to GDP. In other countries the direct monetary injection is much smaller.

Sizing the shock

Economic impact of coronavirus and policy measures, 2020



Sources: BlackRock Investment Institute, central banks, finance ministries, Oxford University, Apple and Google, with data from Haver Analytics, May 2020. We took the sectors likely to be hit the hardest and assessed how severely each has been impacted. Some countries may have stricter lockdowns – measured using the University of Oxford's Stringency index and Apple and Google mobility data. The loss in output depends on the severity of the lockdown and the role of the affected sectors in the economy. We use these estimates of peak-to-trough output decline to approximate the impact on 2020 GDP (orange bars). This analysis is subject to limitations. It does not account for stimulus measures. The dark yellow bars show the fiscal measures that have been announced translated into impact on GDP, using standard fiscal multipliers. The light yellow bars show direct lending to the private sector by central banks. The euro area (EA) has announced 500 billion euros in grants but we don't expect those to be available until 2021.

Investment themes

1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 – but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions and stringent shutdown measures are gradually being lifted.
- The nature of the activity rebound will depend on the path of the outbreak, delivery of policy response and potential changes to consumer and corporate behaviors. Success will not just be about restarting the economy and containing the virus – but balancing both objectives.
- **Market implication:** We are sticking to benchmark holdings in most asset classes and prefer credit over equities.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets has taken shape, particularly in the U.S. The U.S. unemployment rate hit its highest level since the Great Depression in April, underscoring the need for effective policy implementation.
- The Federal Reserve built on its “whatever it takes” approach to helping the economy through the shock and ensuring markets function properly. We could see its balance sheet more than double to nearly \$11 trillion by year end to support the fiscal response. The U.S. Treasury smashed records by setting out a \$3 trillion borrowing plan in its quarterly refunding to fund the response – showing the blurring of lines between monetary and fiscal policy.
- The European Commission unveiled a €750 billion pandemic rescue plan. The size of the common debt raised under the plan, if approved by all 27 European Union members, would be unprecedented.
- China moved away from setting a GDP growth target for 2020, emphasizing *quality* of growth over *quantity*, and announced fiscal stimulus of around 4% of GDP.
- A German constitutional court ruling threatens the European Central Bank's independence and could lead to euro area fragmentation in the long run. It's crucial to have proper guard rails around policy coordination, as we wrote in [Dealing with the next downturn](#).
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments.
- We see risks of implementation and policy exhaustion. Next rounds of U.S. fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship.
- **Market implication:** Coupon income is crucial in an even more yield-starved world, including corporate credit.

3 Resilience rules

- Portfolio resilience has to go beyond nominal government bonds and consider alternative return sources that can provide diversification.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication:** We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for sustainable investing.

Week ahead

June 1	Manufacturing PMI for Japan, euro area, the U.S. and China (Caixin)	June 4	European Central Bank (ECB) monetary policy meeting
June 3	Services PMI for Japan, China (Caixin) and the U.S.; U.S. factory orders; euro area unemployment	June 5	U.S. non-farm payrolls; German industrial orders

This week's ECB meeting and U.S. payrolls data will be the focus. Markets will focus on whether the ECB will increase the size of its pandemic emergency purchase program. How the ECB intends to deal with the German constitutional court ruling and the potential scenario where the Bundesbank has to pull out of the purchase program will be closely watched. The U.S. jobs data may show a further rise in the unemployment rate, after it hit the highest level since the Great Depression in April.

Directional views











Six to 12-month tactical views on major global assets from a U.S. dollar perspective, June 2020

Asset	Underweight	Neutral	Overweight
Equities	<p>We are neutral on global equities. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room.</p>		
Credit	<p>We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.</p>		
Government bonds	<p>We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.</p>		
Cash	<p>We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.</p>		

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, June 2020

Asset	Underweight	Overweight	
Equities			We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
			We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
			We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
			We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
			We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
			We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
			We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
			We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income			We like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
			We are neutral on TIPS. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
			We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
			We are reviewing our overweight in euro area peripheral government bonds. A recent German constitutional court's ruling could potentially limit the size of the European Central Bank's bond buying program.
			We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
			We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities.
			We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced.
			We are neutral on local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon income.
			We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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