

# Weekly commentary

August 24, 2020



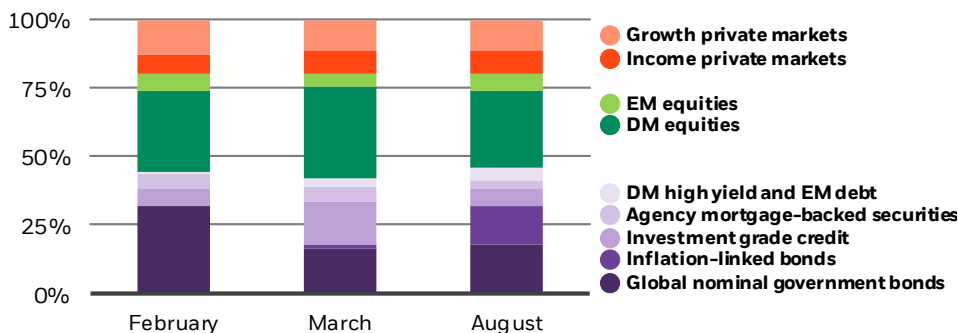
## Strategic views for a post-Covid world

- The Covid-19 pandemic has transformed the investment landscape in a matter of months, prompting a rethink of strategic asset allocation views.
- Negotiations over a new U.S. fiscal package looked to have stalled. We still expect a sizable package, but risks of a no-deal outcome are growing.
- Markets will focus on the annual Jackson Hole meeting for what potential policy framework changes might imply for the medium-term inflation outlook.

The pandemic has sped up key structural trends and triggered substantial market swings, precipitating an urgent need to rethink strategic asset allocations. Among the big changes: We favor reduced exposure to nominal developed market (DM) government bonds and greater allocations to inflation-linked bonds, as interest rates approach their lower bounds and inflation risks grow in the medium term.

### Chart of the week

Hypothetical strategic asset allocations in multi-asset portfolios, 2020



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. Sources: BlackRock Investment Institute, August 2020. Notes: The bars show our hypothetical, unconstrained, U.S. dollar-denominated portfolio built using our portfolio construction approach and capital market assumptions. Global nominal government bonds and emerging market (EM) equity allocations include respective China assets. Income private markets include infrastructure debt, direct lending, real estate mezzanine debt and U.S. core real estate. Growth private markets include global private equity buyouts and infrastructure equity. The hypothetical portfolio is intended for information purposes only and does not constitute investment advice. The indexes representing equities are the MSCI Emerging Markets and MSCI World indexes. The fixed income indexes include Bloomberg Barclays Global High Yield Total Return, U.S. MBS, Global Aggregate - Corporate and Global Treasury indexes, JP Morgan GBI-EM and EMBI Global Diversified indexes, and ICE BofA Merrill Lynch Global Inflation-Linked Government Index. Indexes are unmanaged. It is not possible to invest directly in an index. 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.

Market prices, asset valuations and economic projections have seen big swings in the space of two quarters. This, in turn, has had a sizeable impact on our expected returns and asset views. Anchoring investment views to the past is becoming less relevant, in our view, as structural trends such as rising inequality, deglobalization, the policy revolution and sustainability race toward us. We started the year with a strategic overweight in nominal DM government bonds. Today, this asset class is our biggest strategic underweight. Allocations to nominal government bonds in a hypothetical, U.S. dollar-based strategic portfolio based on our capital market assumptions have been reduced since February. See the darkest purple bars in the chart. We had flagged as early as March growing risks around inflation. Inflation-linked bonds have gone from a neutral to our biggest overweight, with greatly expanded strategic allocations.



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Views on nominal government bonds and inflation are key to constructing strategic portfolios for the post-Covid world. The policy revolution to cushion the Covid shock challenges the role of nominal government bonds in strategic portfolios by lowering their returns and reducing their ballast properties. We expect negative returns across DM government bonds on a five-year horizon. Furthermore, the inverse correlation between bonds and stocks weakens as yields are near perceived lower bounds. This reduces bonds' ballast role, or ability to cushion portfolios against risk asset sell-offs.

We see risks of higher inflation over the medium term. Central banks are already explicitly signalling a greater tolerance to let inflation overshoot their targets to make up for past misses. That could join force with other factors that we see as driving inflation in the medium term: negative supply shocks, deglobalization and reduced competition among large firms. Higher inflation could become more politically tempting as elevated debt levels make it hard to sustain materially higher rates, at a time of explicit monetary and fiscal coordination. Breakeven rates, a measure of market-based inflation expectations, are already on the rise. We see inflation-linked bonds as an increasingly attractive alternative to nominal bonds, even though its limited market size creates liquidity challenges in some markets.

Sharp market swings this year are requiring strategic views to evolve with an unusually high frequency. From late 2018 until the start of this year, we favored a barbell approach in our strategic allocation, preferring equities and government bonds to credit. In March, we made a case for leaning into equity exposures and significantly upgraded credit after a sharp risk sell-off that we saw as excessive, as we expected the unprecedented policy response would make the cumulative impact of the virus shock likely a fraction of that seen after the 2008 global financial crisis. This strategic opportunity has now largely dissipated after the sharp rebound in valuations – and today we are mildly underweight global investment grade credit and DM equities. We still see an important role for private markets and Chinese assets playing in strategic portfolios.

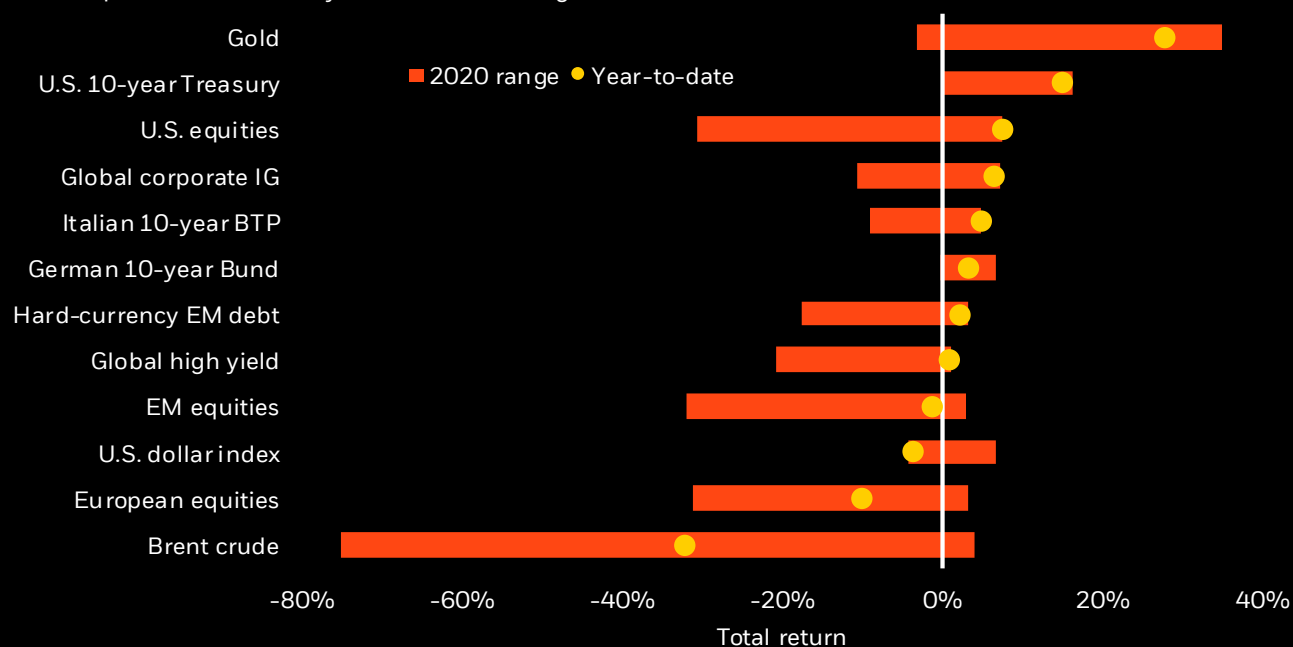
The pandemic dynamics and policy revolution have had different implications on some of our tactical asset views. We still like credit over the next six to 12 months, especially high yield, due to broad policy support and still-attractive valuations. In equities our strongest preference is for high quality exposures, though we have closed our underweight to value-oriented markets broadly and still think Europe has upside among cyclical exposures.

## Market backdrop

Activity has started to normalize around the globe, albeit with renewed localized lockdowns to contain virus clusters. The unprecedented policy response has boosted risk assets. Europe has agreed on a historic recovery fund, but U.S. stimulus is now at risk of fading. Talks over the size and makeup of a new U.S. fiscal package have stalled as some key benefits expired and states face budget shortfalls. Our base case calls for a \$2 trillion fiscal package that extends some federal stimulus measures through late-2020, but there is a risk no deal will materialize. Another risk: escalating 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, August 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 (DXY), 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.

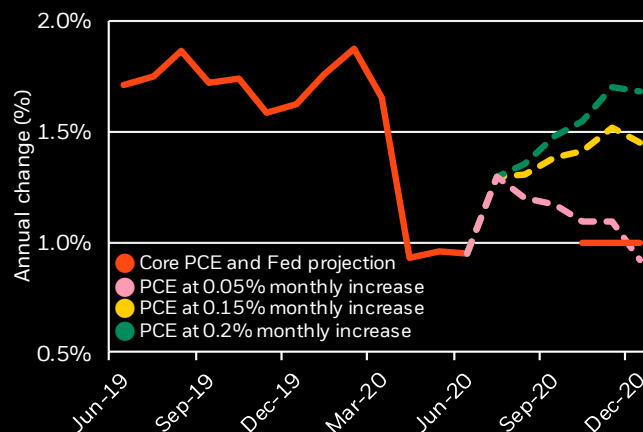
## Macro insights

We believe investors are underestimating the potential for inflation expectations to rise, even in the near term. The surprisingly large rise in the U.S. July Consumer Price Index suggests a more rapid recovery in certain prices that have been hardest hit by the Covid-19 shock, such as airfares and hotels. Those prices remain well below pre-Covid levels, suggesting room for upside moves in coming months.

U.S. inflation is picking up more quickly than Federal Reserve officials were expecting just two months ago. The Fed's June projection for core PCE inflation was for inflation to stay subdued well below its target. But assuming inflation increases at moderate levels on average from August onwards, we could see core PCE inflation climb back to annual rates of 1.5% or higher – well above current levels. This comes as the Fed's July meeting minutes show it is preparing to adopt an “outcome-based” forward guidance on policy. It would allow inflation to run above a 2% target to make up for past misses before considering lifting interest rates.

## Inflation set to warm up

U.S. core PCE inflation in different scenarios, 2019–2020



Sources: BlackRock Investment Institute, U.S. BEA and Federal Reserve, with data from Haver Analytics. Notes: The chart shows U.S. core PCE inflation and the Fed's projection in its June 2020 update. We show three scenarios based on different average monthly increases between August and December. We assume a 0.15% monthly PCE increase in July given the rise in the CPI that month.

## Investment themes

### 1 Activity restart

- Economies are slowly restarting, but at different paces. We are tracking the evolution of the virus and mobility. The longer it takes for activity to restart, the more cracks might appear in the financial system and productive capacity.
- Activity is restarting around the globe, albeit with localized lockdowns to contain virus clusters. The surge of new infections in U.S. Sun Belt states looks to have peaked, but has resulted in a reversal of some reopening measures and is affecting activity. Europe has seen a pickup in cases but nowhere on the same scale as the U.S.
- 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 moderately pro-risk, and express it in an overweight to credit in strategic, long-term portfolios. We prefer Europe among cyclical equity exposures on a tactical horizon.

### 2 Policy revolution

- The policy revolution was needed to cushion the devastating and deflationary impact of the virus shock. In the medium term, however, the blurring of monetary and fiscal policy could bring about upside inflation risks. It's crucial to have proper guardrails around policy coordination, as we discuss in [Policy Revolution](#).
- The Federal Reserve built on its “whatever it takes” approach to helping the economy through the shock and ensuring markets function properly. Now it is preparing to apply inflation and employment objectives to its forward guidance and commitment to provide policy support and keep rates low.
- After a slow start, Europe has followed suit. The European Central Bank started fresh and more flexible quantitative easing. European leaders agreed on a historic €750 billion European recovery plan that introduces mutualized debt and creates jointly issued European bonds that can compete with other perceived safe-haven assets.
- EU leaders appear committed to the recovery plan, but it may take time to implement.
- 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.
- We see a risk of policy exhaustion, especially in the U.S. Negotiations on new fiscal relief measures have stalled. We could see a \$2 trillion fiscal package that extends some federal stimulus measures through late-2020, but there is a risk no deal will materialize. Aid to states and local governments is a key item, with many facing budget holes.
- **Market implication:** We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically, we overweight credit and European equities, and see U.S. stocks at risk of fading fiscal stimulus.

### 3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. Countries and sectors will make a comeback as diversifiers in a more fragmented world, in our view, offering resilience to real economy trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. Investors should consider alternative return sources that can provide diversification, such as private markets.
- 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 sustainable assets, private markets and deliberate country diversification for strategic portfolios. We have increased our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

# Week ahead

**Aug 25** German ifo Business Climate Index; U.S. consumer confidence





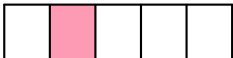



**Aug 28** Euro area business and consumer survey results; German gfk consumer sentiment; ISM-Chicago Business

**Aug 27-28** Annual Jackson Hole Kansas Fed Economic Policy Symposium

The annual gathering of central bankers and other policymakers will be a focus - and it will be conducted virtually and open to the public for the first time. Markets will look for clues for what potential policy framework changes might imply for the medium-term inflation outlook.

## Directional views















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

Asset	Strategic view	Tactical view
Equities	 <p>Neutral</p>	 <p>Neutral</p> <p>We have turned 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 Europe among cyclical exposures.</p>
Credit	 <p>Neutral</p>	 <p>+1</p> <p>We have turned neutral on credit on a strategic basis because we see investment grade spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, extraordinary measures by central banks including purchases of corporate debt are supportive. Risks of a temporary liquidity crunch remain, but coupon income is crucial in a world starved for yield.</p>
Govt bonds	 <p>-1</p>	 <p>Neutral</p> <p>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.</p>
Cash		 <p>Neutral</p> <p>We are neutral on cash. Holding some cash makes sense as a buffer against supply shocks that could drive both stocks and bonds lower.</p>
Private markets	 <p>Neutral</p>	<p>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.</p>

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

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

Asset	Underweight	Overweight		
Equities			United States	 <p>We downgrade U.S. equities to neutral. Risks of fading fiscal stimulus and an extended epidemic are threatening to derail the market's strong run. Renewed U.S.-China tensions and a divisive election also weigh.</p>
			Euro area	 <p>We upgrade European equities to overweight. The region is exposed to a cyclical upside as the economy restarts, against a backdrop of solid public health measures and a galvanizing policy response.</p>
			Japan	 <p>We upgrade Japanese equities to neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.</p>
			Emerging markets	 <p>We downgrade emerging market equities to underweight. We are concerned about the pandemic's spread and see less room or willingness for policy measures to cushion the impact in many – but not all – countries.</p>
			Asia ex-Japan	 <p>We downgrade Asia ex-Japan equities to neutral. Renewed U.S.-China tension is a risk. China's goal to balance growth with financial stability has led to relatively muted policy measures to cushion the virus fallout.</p>
			Momentum	<p>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.</p>
			Value	 <p>We upgrade value to neutral. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance.</p>
			Minimum volatility	 <p>We downgrade min vol to neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.</p>
			Quality	 <p>We increase our overweight in quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy.</p>
	Fixed Income			U.S. Treasuries
			Treasury Inflation-Protected Securities	<p>We are neutral on TIPS. A huge decline in rates makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.</p>
			German bunds	 <p>We remain underweight bunds as current yield levels provide little cushion against major risk events. Also, potential issuance related to the proposed EU recovery fund could compete with bunds for investment.</p>
			Euro area peripherals	 <p>We 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.</p>
			Global investment grade	 <p>We overweight global investment grade credit even as valuations have risen. Asset purchases by central banks and a broadly stable rates backdrop support the sector.</p>
			Global high yield	 <p>We stay overweight high yield as a source of income despite recent underperformance. We avoid energy as lower oil prices challenge the ability of issuers to refinance near-term maturities.</p>
			Emerging market – hard currency	 <p>We have downgraded 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.</p>
			Emerging market – local currency	<p>We remain neutral on local-currency EM debt for its attractive coupon income. Currencies have adjusted and valuations have cheapened. A risk of further currency declines remains amid monetary and fiscal easing.</p>
			Asia fixed income	 <p>We have turned neutral on Asia fixed income. The pandemic's containment in many countries and low energy exposure are positives. Renewed U.S.-China tensions and China's relatively muted policy fallout are risks.</p>

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