

Weekly commentary

Sept. 28, 2020

BlackRock

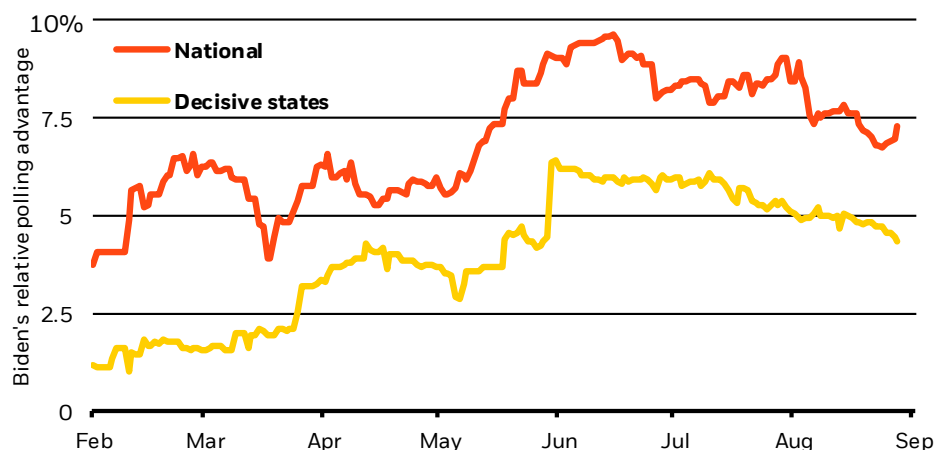
A consequential election

- The U.S. election result is set to have big implications for markets as U.S. fiscal stimulus, public investment, taxation, regulation and foreign affairs could shift.
- The activity restart is running ahead of expectations in developed markets, albeit at different paces as virus dynamics vary.
- Markets will focus on the first U.S. presidential debate, U.S. consumer confidence and employment this week.

The U.S. election is taking place against a historic backdrop of a pandemic, recession and domestic strife. The outcome could have significant implications for key policy areas: fiscal stimulus, public investment, taxation, regulation and foreign affairs. It also has the potential to supercharge structural trends such as an increased policy and market focus on sustainability.

Chart of the week

Biden's national poll advantage vs. lead in decisive electoral states, 2020



Sources: BlackRock Investment Institute, with data from FiveThirtyEight, September 2020. Notes: The orange line shows the advantage of former Vice President Joe Biden over President Donald Trump in national polls. The yellow line shows Biden's average advantage in six decisive states: Arizona, Florida, Michigan, North Carolina, Pennsylvania and Wisconsin.

Democratic nominee and former Vice President Joe Biden looks to have an edge in the race, leading President Donald Trump by about seven percentage points in recent national polls. This lead has been remarkably stable this year. Yet his lead is narrower in decisive electoral states that could still give Trump a path to re-election. See the chart. The contest for the U.S. Senate – key to a potential Biden administration's ability to implement its agenda – appears close to a tossup. We see three plausible scenarios to plan for: 1) a Democratic sweep of the White House and Congress (with Democrats winning control of the Senate); 2) a Biden win with a divided Congress; and 3) a status quo Trump win. The pandemic has helped create historically challenging circumstances for the election, including a leap in mail-in voting that could complicate vote counting, delay results and trigger legal challenges. We see a material risk of a contested election or a delayed result. Election day could turn into weeks or months.



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We see fiscal policy as the most critical area to watch, as it has been helping bridge the economy through the Covid shock. The two Biden victory scenarios would look very different through this fiscal lens, in our view. A Democratic sweep would likely pave the way for a new round of large-scale fiscal stimulus and boost spending on clean energy, transport and housing – but also increase taxes for companies and the wealthy. A Biden win with a Republican-controlled Senate would lead to much less ambitious fiscal stimulus and infrastructure spending, and no major tax changes. The net difference in fiscal spending between the two scenarios could be several percentage points of GDP over each of the next few years, we estimate. Fiscal spending under a second Trump term would be somewhere in the middle between those two scenarios.

The election result will have implications for the key geopolitical risks we track. A Biden win – under either scenario – would likely signify a return to more predictable trade and foreign policy, supporting emerging market assets and broader risk sentiment in the short term. Yet we see U.S.-China rivalry staying structurally elevated across dimensions such as technology, trade and investment under Biden, due to bipartisan support for a more competitive stance on China. Climate policy would also be a major focus. The U.S. would likely immediately rejoin the Paris Agreement and increase its emissions reduction goals. Its fiscal plans could help supercharge a globally coordinated green stimulus effort, adding to recent efforts by the European Union. A Trump win, by contrast, would likely lead to a doubling-down of the “America First” stance on trade and immigration.

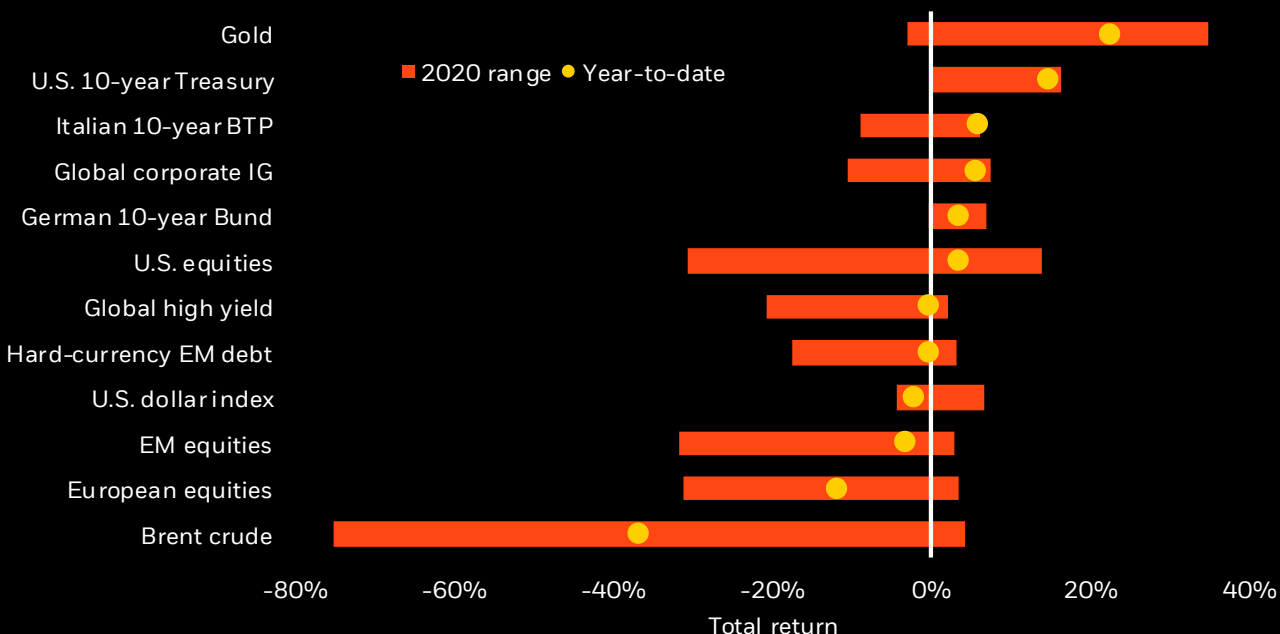
We think a “tax-centric” election analysis – with a Democratic sweep seen as a market negative, and divided government a positive – is too simplistic. In a Democratic sweep scenario for example, investors would have to balance higher taxes and tighter regulation with greater fiscal support and predictable foreign policy. We see the main implications of this scenario in fixed income and leadership in equity markets. It could push long-term rates higher and lead to a modest steepening of the Treasury yield curve. Domestically oriented equities, including small caps, might benefit the most, whereas higher taxes and tighter regulation could pressure large caps. This scenario would add to reasons to prepare for a higher inflation regime and reinforces our strategic underweight of developed market nominal government bonds. The tectonic shift to sustainable investing will likely persist regardless of the result, but could be supercharged under a Democratic sweep scenario.

Market backdrop

Economic activity is running ahead of expectations in developed markets, albeit at different paces due to varying virus dynamics. Market volatility is returning after months of steady advances in risk assets, and we see elevated volatility ahead of the November U.S. election. The window appears to be closing for any new U.S. fiscal package before the election. The pandemic is still spreading in many countries; and U.S.-China tensions are running high.

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, September 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.

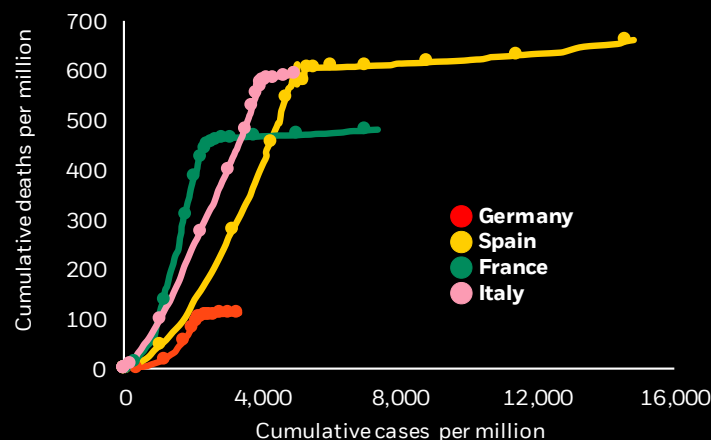
Macro insights

The increase in Covid cases in the euro area may not foreshadow a return to full national lockdowns. The growing cases partly reflect a greater number of tests. Importantly, fatality rates have not risen in line with cases, as the average age of new Covid patients has dropped. Better testing and the slower growth in fatalities mean authorities have more time to respond to local flareups and improve track-and-trace capabilities. Mask-wearing mandates and social distancing laws appear to be helping slow the spread of the virus.

The euro area's restart is still outpacing expectations, yet it appears to be losing momentum. Mobility in the region is now just 10% below pre-Covid levels, versus 25% in the U.S. The recovery has slowed in locations where infection rates have picked up, but the direction of travel still points to increasing mobility. Industrial production and construction have recovered strongly, especially in Italy and Spain. The services rebound has been more mixed, reflecting a tough environment for contact-intensive sectors.

A less fatal infection spike

Euro area cumulative Covid-19 cases and deaths, 2020



Sources: BlackRock Investment Institute and Our World in Data, with data from Haver Analytics, Sept. 2020. Note: the dots show 14 day intervals in case and fatality counts. Widespacing between dots denotes faster growth. A measurement change in Spain accounts for the slight drop in deaths.

Investment themes

1 Activity restart

- The activity restart has broadened and is running ahead of expectations in developed markets, as reflected by the IMF's recent signaling of an upgrade to its global growth outlook. Yet the restart is moving at different speeds across countries, driven by differences in virus dynamics.
- We see localized restrictions as the main virus control approach over coming months, and a return to full national lockdowns as unlikely. Fatality and hospitalization rates per infection have dropped even with higher case counts.
- 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.
- The risk of fiscal fatigue is crystallizing in the U.S., raising concerns about the recovery running out of steam. Negotiations on extending fiscal support have stalled, with an increasing risk that we will see no fiscal package before the Nov. 3 election.
- Market implication:** We are moderately pro-risk, and express it in an overweight in high yield – in both strategic and tactical portfolios. We have a preference for cyclical assets in Europe.

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.
- 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-19 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 a strategic horizon. 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 believe countries, sectors and companies will make a comeback as diversifiers in a more fragmented world, 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 are overweight the quality factor on a tactical horizon, favor assets with policy backstops, and generally prefer developed markets over the emerging world.

Week ahead

Sept. 29

The first U.S. presidential debate, U.S. consumer confidence

Oct. 1

Japan, euro area, UK, U.S. manufacturing PMI

Sept. 30

China official manufacturing purchasing managers' index (PMI); euro area flash inflation

Oct. 2

U.S. nonfarm payrolls

The first U.S. presidential debate will be a focus. Some U.S. data next week will be key for gauging the status of the economic recovery. Markets expect U.S. consumer confidence to rebound from a six-year low in August, and nonfarm payrolls to grow at a slower pace than a month earlier. Concerns about the recovery running out of steam are rising as the risk of fiscal fatigue is crystallizing in the U.S.

Directional views

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

Asset	Strategic view	Tactical view
Equities	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <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	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <p>+1</p> <p>We have turned 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.</p>
Govt bonds	<div><div></div><div></div><div></div><div></div><div></div></div> <p>-1</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <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		<div><div></div><div></div><div></div><div></div><div></div></div> <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	<div><div></div><div></div><div></div><div></div><div></div></div> <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, September 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, September 2020

Asset	Underweight	Overweight	
Equities	United States		We are neutral on U.S. equities. 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.
	Euro area		We are overweight European equities. 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.
	Japan		We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
	Emerging markets		We are underweight emerging market equities. 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.
	Asia ex-Japan		We hold Asia ex-Japan equities at 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.
	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 hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.
	Quality		We keep our strong overweight on quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy.
Fixed Income	U.S. Treasuries		We still like U.S. Treasuries. Long-term yields are likely to fall further than other developed market peers, even as low rates reduce their ability to cushion against risk asset selloffs.
	Treasury Inflation-Protected Securities		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.
	German bunds		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.
	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 downgrade investment grade credit to neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
	Global high yield		We increase our 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 have downgraded local-currency EM debt to underweight. 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 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.

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