

Weekly commentary

Oct. 5, 2020



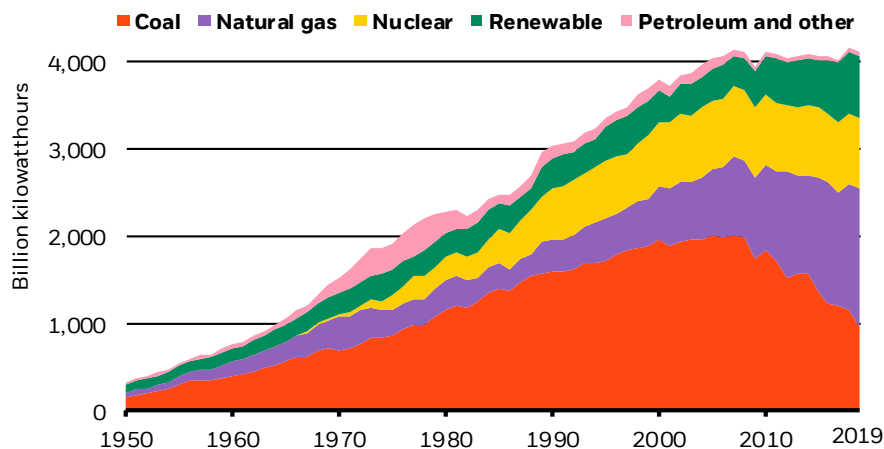
U.S. election through a sectoral lens

- We zoom in on the implications that the U.S. election may have on three key sectors: energy, technology and healthcare.
- U.S. President Donald Trump has tested positive for COVID-19, adding to near-term election uncertainties. U.S. fiscal package negotiations continued.
- Markets will focus on services purchasing managers' index (PMI) data from key economies to gauge the pace of the economic recovery.

The potential outcomes of the November U.S. election could have starkly different policy ramifications, as we argued **last week**. What will this mean for equity markets? We believe simplistic narratives about the overall market direction are best avoided – and see the biggest election-related implications playing out within asset classes and sectors. We zero in on energy, tech and healthcare.

Chart of the week

U.S. electricity generation by major energy sources, 1950-2019



Sources: BlackRock Investment Institute, with data from the U.S. Energy Information Administration, October 2020. Notes: The electricity generation is from utility-scale facilities. Data for 2019 are preliminary.

A win by former Vice President Joe Biden – along with Democrats taking control of the Senate – could help accelerate a shift toward sustainability that is already under way. His climate policy would focus on four areas: electric power, transport, buildings and research and development (R&D) spending. The share of electricity generated by renewable sources has grown steadily in the U.S. – from 10% in 2010 to 17% in 2019 – according to the U.S. Energy Information Administration. See the chart above. A Democratic sweep could accelerate the decarbonization of the power sector, by extending and expanding tax credits for renewable power sources and other zero-carbon industrial sources such as carbon sequestration. The Biden campaign has also proposed significant investment to reduce emissions in the transport sector, and to retrofit commercial and municipal buildings to increase their energy efficiency. Industries such as solar may already have largely priced in the transition to clean energy, yet we see other opportunities, such as energy-efficient technologies and offshore wind power.



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How much of Biden’s climate policy proposal would become reality if he won the election? A Democratic sweep would likely lead to a large boost to public investment in clean energy. Fiscal spending would be significantly more constrained under a Biden win with divided government. Much could still happen on the regulatory front, such as tightening rules on oil and gas exploration, production and transmission. A crackdown on drilling and pipeline permits could constrain U.S. shale supply and push oil prices up, especially as demand recovers post-COVID. Yet any spike in oil prices may not be sustained given the prospect of an accelerating shift to clean energy in the transport sector. We see opportunities in private markets across renewables, digital infrastructure and transport regardless of the election result, given the structural shift to sustainability.

The tech sector – which has led the market in 2020 – is also in the spotlight. Concerns around data privacy and market power make tech regulation an area of growing bipartisan concern. Yet a Biden administration would likely bring more strenuous anti-trust reviews, including around issues such as wages and platform power. Tax reforms in a Democratic sweep scenario could also weigh in particular on global tech giants. We view the regulatory risks faced by mega-cap tech companies as manageable overall, as many have already adjusted to tougher data privacy rules in Europe. We see potential for leadership within the sector to broaden to a wider set of beneficiaries across different themes including 5G connectivity. Software and semiconductors could lead the charge, as they face fewer regulatory risks and enjoy long-term growth trends. Some tech companies could also benefit from the clean energy transition and a shift toward greater energy efficiency.

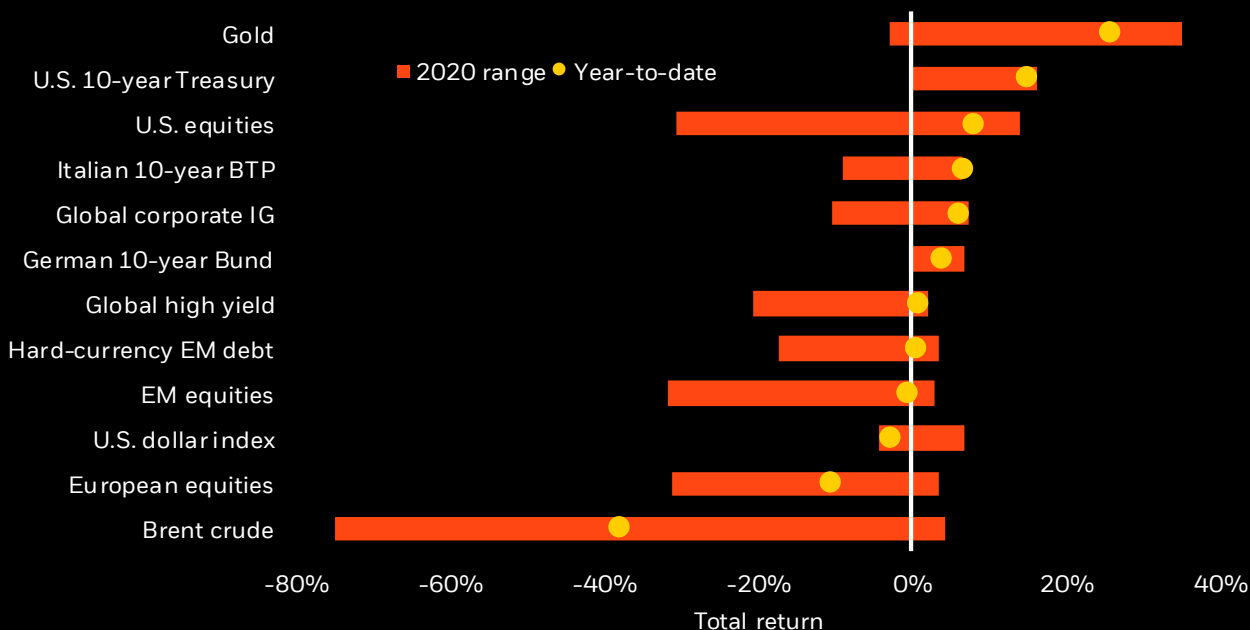
We see healthcare policy as relatively stable in the first year of a potential Biden administration – as opposed to early in the first terms of President Barack Obama and President Donald Trump, when it was a principal focus of the policy discussion. COVID response, economic recovery and climate-related initiatives would likely take priority in 2021, in our view. A risk to this view: The Supreme Court is scheduled to hear a case on the Affordable Care Act a week after the election, potentially pushing the healthcare debate back to the front burner. Measures to curb drug price increases are a potential focus – regardless of the election result. Yet we would expect only modest action against the backdrop of the pandemic, as drug makers are playing an important role in vaccine development and COVID response. Overall we favor medical devices, life sciences and diagnostics companies, as well as some diversified large-cap pharmaceuticals in Europe.

Market backdrop

Economic activity is still running ahead of expectations in developed markets, albeit at different paces due to varying virus dynamics. COVID infections have picked up in Europe and parts of the U.S. President Trump has tested positive for COVID-19, against the backdrop of a race that has remained largely stable despite historic events including the deadly pandemic, mass unemployment and racial tensions. Negotiations continued on a new U.S. fiscal package, with a softer-than-expected September jobs report adding urgency even as the political parties are far apart and the legislative window is closing.

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, October 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.

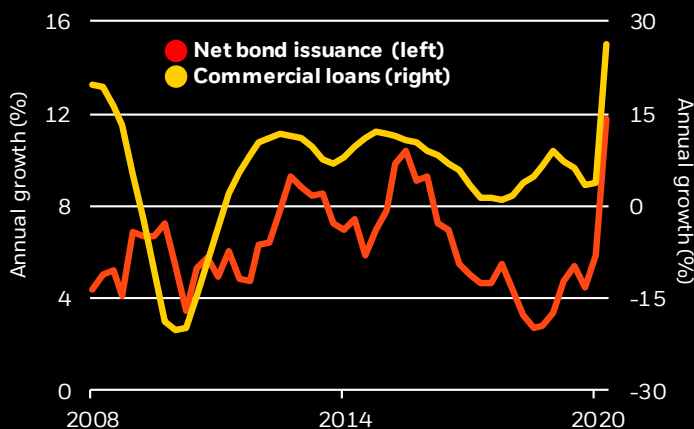
Macro insights

U.S. corporate borrowing has surged since the onset of the pandemic. There are fears this borrowing spree could lead to rising bankruptcies once government support dried up. High corporate debt levels have been a problem in past recessions – notably in the global financial crisis (GFC). This time may be different.

There was little overheating in the economy and financial system before the pandemic. Business borrowing has accelerated over the past six months to help plug sudden income shortfalls and protect productive capacity. Corporate bond issuance, the mainstay of U.S. business funding, has risen sharply. So has U.S. bank lending – driven by government Paycheck Protection Program loans. In contrast, a borrowing spurt had preceded the GFC, driven by excessive optimism and easy financing. Once the crisis started, borrowing ground to a halt. The dynamics today support our view that the cumulative impact from COVID over time should be a fraction of that caused by the GFC.

Business borrowing boom

U.S. non-financial bond issuance and borrowing, 2008–2020



Sources: BlackRock Investment Institute and Federal Reserve, with data from Haver Analytics, Oct. 2020.
Note: The orange line (left axis) shows year-on-year growth in net non-financial corporate bond issuance in the U.S. The yellow line (right axis) shows year-on-year bank loans to non-financial businesses in the US.

Investment themes

1 Activity restart

- The activity restart has broadened and is still 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.
- COVID infections have picked up in Europe and parts of the U.S. We still 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.
- **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.
- Risks of policy fatigue are rising. There are growing concerns that the U.S. recovery may lose steam without further fiscal stimulus. Negotiations continued on a pre-election fiscal package even as the political parties are far apart and the legislative window is closing. We also see a need for the European Central Bank to step up its relief programs to cushion the euro area economy.
- 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 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 these 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

Oct. 5

Services purchasing managers' index (PMI) for the U.S., Japan, France and Germany; euro area composite PMI

Oct. 9

China Caixin services PMI





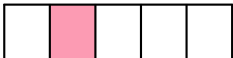



Oct. 6

Germany industrial orders and output; U.S. international trade

This week will see a flurry of PMI data in the services sector of key economies – providing markets with some gauge on the state of the recovery in the sector that has been lagging the restart in manufacturing. Data from some European countries where COVID infections have risen will be of heightened interest to markets.

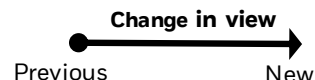
Directional views

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

Asset	Underweight	Overweight		
Equities			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.	
		■	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.	
			We keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.	
		■	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.	
			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.	
			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.	
			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.	
			We hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.	
			■ ■	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		■	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.	
			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.	
		■	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.	
		■	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.	
			We hold investment grade credit at 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.	
			■ ■	We keep our strong overweight on highyield. 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.
		■	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.	
		■	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.	
				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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