Weekly commentary

BlackRock.

September 20, 2021

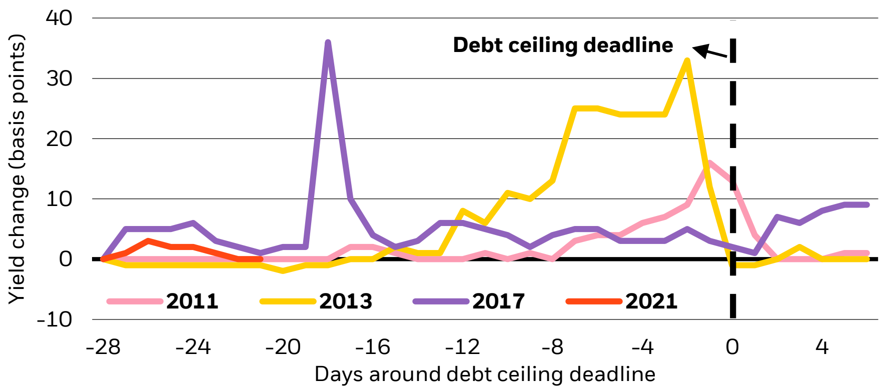
Debt ceiling showdown redux

- We remain pro-risk and opt to look through any short-lived volatility that could result from a battle over lifting the U.S. debt limit and funding the government.
- U.S. consumer price increases slowed in August, but inflation pressure has broadened to core items less affected by the pandemic.
- Several central bank policy meetings are in focus. We don't expect growing inflation pressure to lead to an earlier rate liftoff by the Federal Reserve.

The U.S. needs to soon raise a self-imposed federal debt limit, or the "debt ceiling", to avoid a debt default. We don't see fundamental risks from the debt ceiling showdown – with a low risk of technical default and limited chance of a temporary government shutdown. Yet the twists and turns could trigger jitters in markets that have had an extended run higher. Still, we favor looking through any volatility and stay pro-risk over the next six to 12 months.

Calm before the storm?

Changes in 4-week Treasury Bill yields during debt ceiling episodes



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2021. Notes: The chart shows changes in yields of 4-week Treasury Bill (T-Bill) yields from 28 days before the debt ceiling "deadlines", or the dates when the federal government exhausts its borrowing in selected debt ceiling episodes. These deadlines are August 2, 2011, Oct. 17, 2013, Sept. 29, 2017. We use Oct. 15 as the projected debt ceiling "deadline" for this year.

The Congress has acted to adjust the debt ceiling 78 times since 1960, according the Treasury Department. Over recent decades the debt ceiling has become a subject of intense partisan wrangling. A two-year debt ceiling suspension expired in July, and the Treasury Department said its "extraordinary measures", or maneuvers to manage cash and debt in order to avoid breaching the debt limit, could run out next month if Congress doesn't act. So far we have only seen modest movements at the front end of the Treasury yield curve – in line with market reaction ahead of recent debt ceiling deadlines with the exception of 2017. See the chart above. We see today's unique market dynamics as contributing to the muted signal from the Treasury market. The Federal Reserve's near-zero policy rate has intensified the hunt for yield, just as the central bank has become a large buyer of Treasuries. In addition, banking regulations since 2008 have helped broaden the buyer base for Treasuries.

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Today's macro environment is very different from previous debt ceiling episodes over the past decade. An economic restart is underway in the U.S., and inflation pressure has increased amid pandemic-related supply disruptions. We uphold our tactical pro-risk stance as the restart broadens out, and what we call *the new nominal* – a more muted reaction from central banks to higher inflation than in the past – is also supportive of risk assets. This is in contrast with the debt ceiling showdown in 2011 that triggered a downgrade in the United States' AAA sovereign credit rating by S&P just as the euro area debt crisis and worries about slower growth kept investors on their toes. It also differs from 2018, when worries about U.S.-China trade tensions and their impact on the economy were flaring up.

How will the debt ceiling showdown affect the prospects of Congressional spending plans? We believe it will unlikely derail the $1 trillion bipartisan infrastructure bill or the Democrats' proposed $3.5 trillion spending plan on social policy and climate change - key legislative priorities ahead of the 2022 midterm elections. Yet we do expect the $3.5 trillion price tag on the Democratic-sponsored reconciliation package to be scaled down to help ensure the support of party moderates, who have balked at some of the proposed tax increases for corporates and high-earning individuals to offset spending.

We believe Congress will ultimately reach an agreement to raise or extend the debt limit, but likely not until right before the Treasury exhausts its borrowing capacity. That may come in late October or early November, but the timing is hard to estimate due to lumpy Treasury cash flows for Covid relief payments. The good news: Neither political party wants to see a technical default, and there are no calls for substantive spending cuts. Hence we do not believe the debt ceiling represents a fundamental risk to the market. The risk: The timeline to resolve the debt ceiling is tight. Political brinksmanship appears likely, and any miscalculation could lead to a short-lived government shutdown that triggers market volatility.

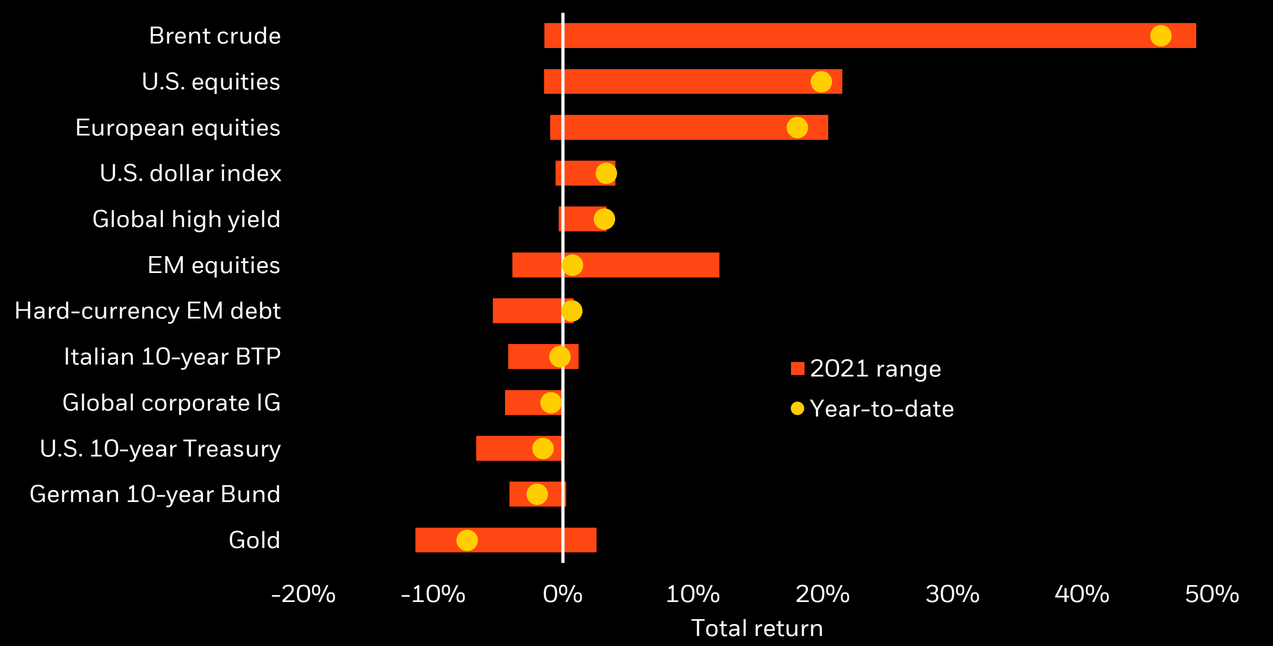
Bottom line: We expect Congress to ultimately reach an agreement on the debt ceiling, and see the odds of the federal government committing technical default –or violating terms of its debt - as low. Risk assets could suffer temporary pullbacks after an extended run higher, but we favor looking through any volatility and staying pro risk over the next six to 12 months. We recently downgraded U.S. equities to neutral on a tactical basis to fund an upgrade to European equities, as we see the baton of global restart being passed on to Europe from the U.S.; we remain underweight U.S. government bonds.

Market backdrop

The U.S. consumer price index (CPI) showed a slower pace of price increases in August, thanks to a moderate rise in core components and falling prices in Covid-related items such as airfares and car rentals. Yet price pressures appeared to grow in some non-Covid items, suggesting a broadening and more persistent inflationary pressure.

Assets in review

Selected asset performance, 2021 year-to-date and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Sept. 16, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current 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, in descending order: spot Brent crude, MSCI USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, J.P. Morgan EMBI Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream U.S. 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and spot gold.

Macro insights

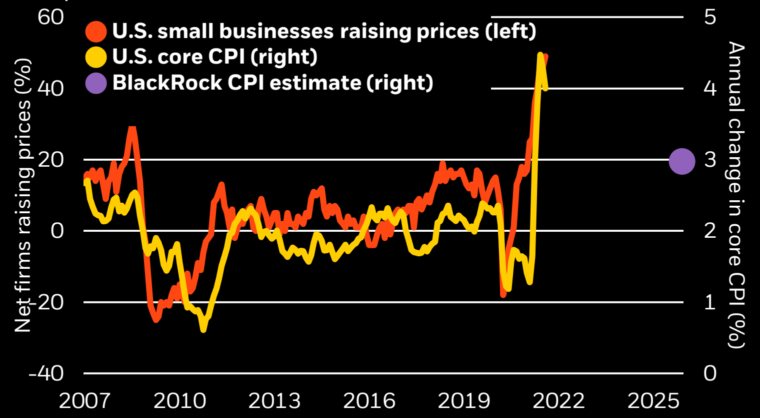
The August U.S. Consumer Price Index (CPI) showed a surprising cooling of core price pressures. Some of the categories seeing a spike during the restart, such as used car prices, are starting to cool.

The data also confirmed that it's still difficult to anticipate month-to-month swings given the unique nature of the restart. Ultimately we expect some of the supply-demand mismatches driving the volatility in prices should subside. We saw some evidence of that in this report, such as with airfares and other travel prices.

Our medium-term inflation view – see the purple dot in the chart – is not just about these restart dynamics. More persistent forces are at play. These include new objectives for major central banks to tolerate higher inflation, and the journey to net-zero carbon emissions. The service sector has held up reasonably well despite the delta variant surge, contributing to the persistent price pressure. We see these and other factors keep inflation higher in the medium term. See our macro insights hub.

U.S. inflation set to stay higher

Firm price trends, core CPI and our inflation estimate, 2007-2025



Sources: BlackRock Investment Institute, National Federation of Independent Business (NFIB), U.S. Bureau of Labor Statistics,, with data from Refinitiv Datastream and Haver Analytics, September 2021. Notes: the orange line shows the net number of firms in the NFIB survey of small and medium-sized businesses reporting that they are currently raising their prices. A value of 0 indicates that the same number of firms are raising and reducing prices. The solid yellow line shows the annual change in the U.S. core CPI inflation rate.

Investment themes

1 The new nominal

- The powerful economic restart is broadening, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- We expect the Fed to start normalizing policy rates in 2023, a much slower pace than market pricing for lift-off in 2022 indicates. Fed Chair Jerome Powell reassured markets at the recent Jackson Hole symposium, making no announcement on tapering but giving a strong signal that one will come before year-end if employment gains keep up. He also made clear that tapering "will not carry a direct signal" with respect to a lift-off in policy rates.
- The ECB tweaked its forward guidance after having recently set its inflation target at 2% in the medium term but rejecting an average inflation targeting framework. The central bank said it would keep policy rates on hold until it had seen "inflation reaching 2% well ahead of the end of the projection horizon and durably for the rest of the projection horizon."
- **Tactical implication**: We go overweight European equities and inflation-linked bonds. We cut U.S. equities to neutral.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is already a distinct pole of global growth. We believe it is time to also treat it as an investment destination separate from EM and DM.
- Chinese authorities have started loosening policies as growth slows, yet we believe they will maintain the broadly hawkish policy stance over the medium term to stay focused on the quality of the growth.
- We believe the clampdown on some private industries could go on for years, but its intensity would likely fluctuate. We have yet to see the peak of the regulatory campaign, but could see its pace and intensity to moderate amid slower growth.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We break out China from EM with a neutral stance on equities and an overweight to debt.
- **Strategic implication:** Our neutral allocation to Chinese assets is multiples larger than typical benchmark weights.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of prices of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

Sept. 20 Canada federal election

Sept. 21-22 Fed, Bank of Japan policy meetings

Sept. 23 Euro area flash consumer confidence indicator; Bank of England policy decision; flash composite purchasing managers' index (PMI) for the euro area, U.S. and UK.

Central banks return to the limelight this week amid rising and more persistent inflationary pressure. Yet we do not expect the growing price pressure to lead to an earlier policy rate liftoff from the Fed. PMI data from key developed economies could shed light on the impact of the delta variant surge on activity restart.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballast with yields near lower bounds. Rising debt levels may eventually pose risks to the low-rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
Private markets	Neutral		We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, September 2021. 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 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We are overweight European equities on the back of the broadening restart. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			While overweight on a strategic basis, we see near-term risks. Growth is slowing at the same time as policy stance is tight – and may not respond in a timely way as authorities focus on the quality of growth. The anti-monopoly clampdown is ongoing.
Equities	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. The anti-monopoly clampdown in the heavyweight Chinese tech sector and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries, primarily on valuations. We see the balance of risks tilting toward gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We initiate a view on Chinese government bonds with an overweight. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We remain underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield credit after the asset class' strong performance. Spreads are now below where we see high yield as attractively valued. We prefer to take risk in equities.
Fixed Income	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
Fixed Income	Emerging market – local currency			We are neutral local-currency EM debt. and see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring, in our view.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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