Weekly commentary

Jan. 19, 2021

BlackRock

A bipolar U.S.-China world order

- A bipolar U.S.-China world order is at the center of the rewiring of globalization. We believe investors need exposures to both poles of global growth.
- U.S. stocks eased from record highs. President-elect Joe Biden introduced a $1.9-trillion spending plan.
- Markets will focus on two major central banks this week, particularly on how the European Central Bank views the recent rise in bond yields.

The pandemic has accelerated the rewiring of globalization – with a bipolar U.S.-China world order at its center. We see the Biden administration taking a sharply different approach to China in trade and climate policy. Yet overall tensions look set to stay elevated amid ongoing economic and technological competition – and we believe investors need exposures to both poles of global growth.

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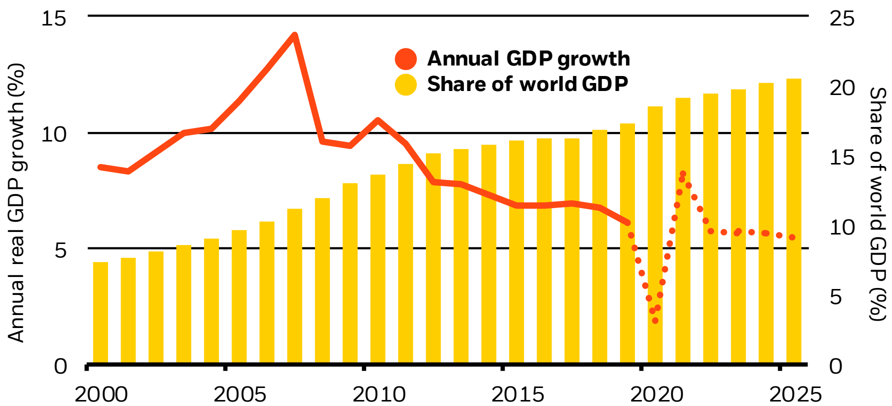
Chart of the week

China annual growth and share of world GDP, 2000-2025



Sources: BlackRock Investment Institute and the International Monetary Fund (IMF), with data from Haver Analytics, December 2020. Notes: The orange line shows China's annual real GDP growth rate. The dotted lines are IMF forecasts. The yellow bars show China's past and expected share of global GDP. **There is no guarantee any forecasts made will come to pass.**

Globalization rewired, one of the three key investment themes introduced in our 2021 global outlook, is about an acceleration of geopolitical transformations. At its center: a bi-polar U.S.-China world order and the remapping of global supply chains. This is not the same as deglobalization. China is opening its capital markets to global investors, and still attracting foreign investment. China's share of global GDP is approaching 20% - more than four times its weight in 2000 – even as its growth rate has slowed over time. See the chart above. China's growth has returned to the pre-pandemic trend, leading other major economies in recovering from the Covid shock. China new five-year plan is expected to include a heightened focus on developing key technologies, pursuing net-zero carbon emissions and allowing greater market pricing of credit risk. Against this backdrop we expect U.S.-China relations to continue to be marked by intense rivalry, particularly in technology, as both countries seek self-sufficiency in critical industries of the future. China is looking to master foundational technologies such as semiconductors, in which it has traditionally lagged the U.S.

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We expect a clear change of tenor and tone in the Biden administration's foreign policy approach, including a shift to working with allies on key issues: China, Russia, Iran, democracy and cyber security. The Biden administration will likely use alliances with groups of countries to engage with China on issues such as trade and technology. The nomination of veteran diplomat and Asia specialist Kurt Campbell to serve the new role of Indo-Pacific Coordinator is a signal of such an approach – as well as the administration's expectation that intense competition is likely to dominate U.S.-China relations. This is taking place as China has emerged stronger from 2020 with its successful containment of the virus and a lead in the economic restart. It has also signed important trade deals including an investment agreement with the European Union, and a regional free trade agreement with a number of Asia-Pacific nations including Japan and South Korea.

Climate is likely to become a central priority of both domestic and foreign policy under the Biden administration – and an area for potential cooperation amid broader tensions in U.S.-China relations. The Biden administration plans to rejoin the Paris Agreement on climate change, and has nominated former Secretary of State John Kerry as U.S. climate envoy. China has committed to sharply reduce the carbon intensity of its economy over the next decade – and aim for net zero carbon emissions by 2060. The administration will likely seek to balance cooperation on climate change and public health within a broader U.S.-China agenda that includes areas of potential heightened tensions such as trade and human rights. Frictions may extend to the financial arena, as evidenced in the forced delisting of some Chinese companies in the U.S. market. We see this as a reason for carefully implementing China exposures, perhaps including greater direct allocations to China-listed securities over time. Yet how to implement China exposures will depend on investor constraints, including political and legal ones.

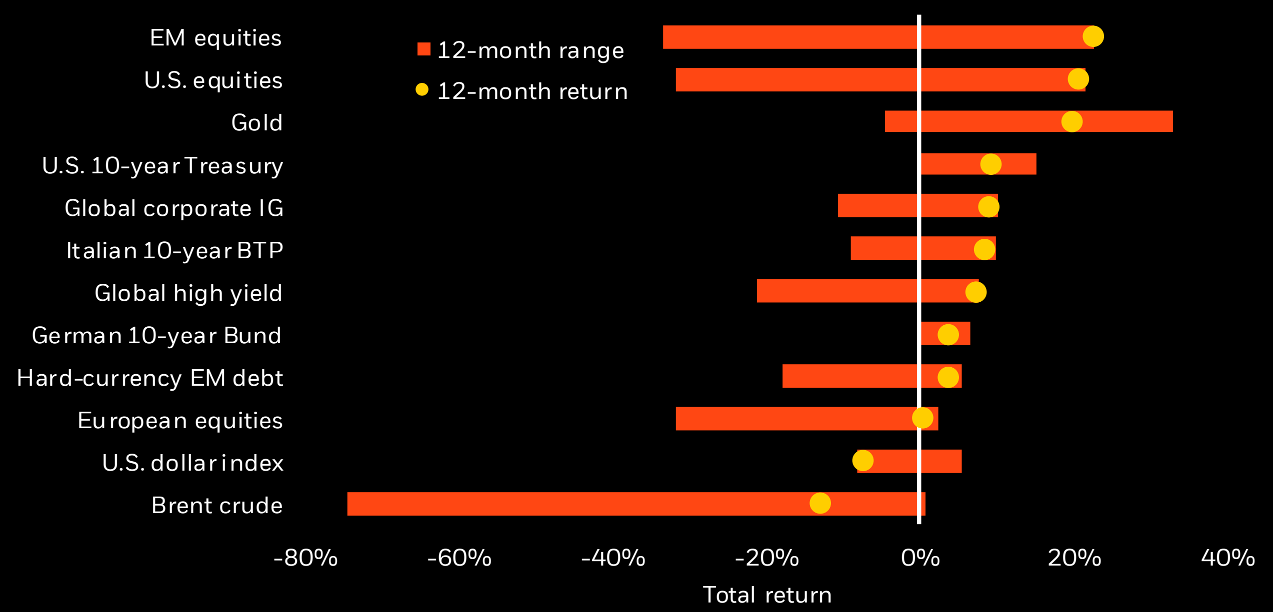
The bottom line: We believe investors need exposure to both poles of global growth in an increasingly bipolar U.S.-China world order. Strategically, we see assets exposed to Chinese growth as core holdings that are distinct from emerging market exposures. There is a clear case for greater portfolio allocations to China-exposed assets for returns and diversification, in our view. Tactically, we are overweight Asia ex-Japan equities as many Asian countries have been more effective at containing the virus and are further ahead in the economic restart. Risks to China-exposed assets include China's high debt levels, currency volatility and heightened U.S.-China conflicts. But we believe investors are well compensated for these.

Market backdrop

U.S. stocks eased from record highs as President-elect Joe Biden announced a proposed $1.9-trillion fiscal package. U.S. Congress has launched impeachment proceedings against President Donald Trump for the second time. The early stages of the vaccine rollout have been slower than expected as a more infectious strain of the virus is spreading, but we don't see this materially changing the cumulative economic impact of the virus shock.

Assets in review

Selected asset performance in the past 12 months



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2021. Notes: The two ends of the bars show the lowest and highest returns over the last 12 months, and the dots represent returns compared with 12 months earlier. 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 gold, Datastream 10-year benchmark government bond (U.S. , German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

Macro insights

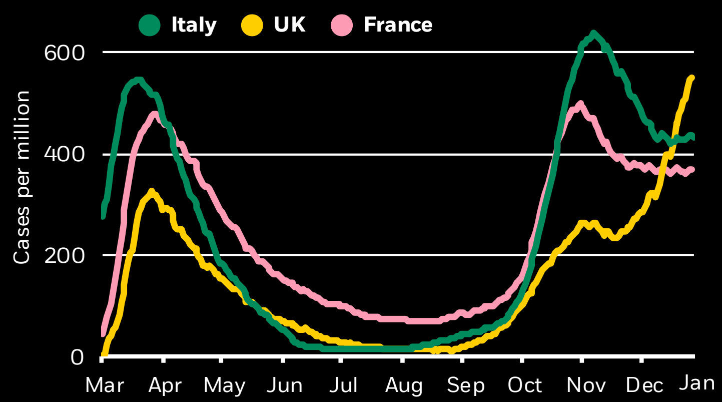
Europe currently provides the clearest example of the challenges caused by a more transmissible virus and a sluggish start to vaccination campaigns. Resulting tighter restrictions could delay the economic restart. Yet we still see the cumulative shortfall in economic activity – what matters most for asset prices – to be just a fraction of that seen after the global financial crisis.

The relationship between restrictions and economic activity seems to have changed since the first peak of infections. Our research shows restrictions are likely to be broadly on par with their peaks last spring yet the decline in economic activity is expected to be more muted, for two reasons.

First, activity in many services sectors is already compressed relative to pre-Covid levels, with less room to decline compared with the first half of 2020. Second, businesses have, to the extent possible, already adapted to an environment of social distancing. Many have built out e-commerce channels and contactless processes, allowing operations to continue despite restrictions.

A renewed surge

Covid patients in hospital per million population, Jan 2021



Sources: BlackRock Investment Institute, with data from the European Center for Disease Prevention and the UK government, January 2021. Notes: The chart shows the level of Covid-related hospitalizations relative to each country's population. The data may not be comparable across countries due to differences in definitions and measurement of data.

Investment themes

1 The new nominal

- We see stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. Inflation will have different implications to the past.
- The policy revolution as a response to the Covid shock implies that nominal yields will be less responsive to rising inflation risk than in past episodes. This suggests risk assets will perform better than in past inflationary periods.
- The Democrats' slim majority in U.S. Congress improves the outlook for fiscal spending, likely fast tracking our expectations for stronger growth and lower real yields.
- Medium-term inflation risks look underappreciated. Production costs are set to rise on a rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past inflation undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- **Market implication**: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by falling real rates. Tactically we are pro-risk, preferring U.S. equities and high yield credit.

2 Globalization rewired

- The pandemic has accelerated geopolitical transformations such as a bipolar U.S.-China world order, and a rewiring of global supply chains for greater resilience. We believe investors need exposure to both poles of global growth.
- Strategic U.S.-China rivalry looks here to stay, particularly in tech. The Biden administration is likely to shift away from a focus on bilateral trade deficits to a multi-lateral approach in trade. The administration will likely seek to balance cooperation on climate change and public health within a broader U.S.-China agenda that includes areas of potential heightened tensions such as trade and human rights.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a clear case for greater exposure to China-exposed assets for returns and diversification, in our view.
- We expect persistent inflows to Asian assets as many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels, yuan depreciation and U.S.-China conflicts. But we believe investors are well compensated for these.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like EM equities, especially Asia ex-Japan, and are underweight Europe and Japan.

3 Turbocharged transformations

- The pandemic has added fuel to pre-existing structural trends such as an increased focus on sustainability, rising inequality within and across nations, and the dominance of e-commerce at the expense of traditional retail.
- The pandemic has focused attention on underappreciated sustainability-related factors and supply chain resilience.
- It has also accelerated "winner takes all" dynamics that have led to the outperformance of a handful of tech giants in recent years. We see tech as having long-term structural tailwinds despite its increased valuations, yet it could face challenges from higher corporate taxes and tighter regulation under a united Democratic government.
- The pandemic has heightened the focus on inequalities within and across countries due to the varying quality of public health infrastructure – particularly across EMs – and access to healthcare.
- **Market implication**: Strategically we prefer sustainable assets amid a growing societal preference for sustainability. Tactically we take a barbell approach, favoring quality stocks balanced with selected cyclical exposures.

Week ahead

Jan. 19 Germany ZEW Indicator of Economic Sentiment

Jan. 21 European Central Bank policy meeting; Bank of Japan policy meeting

Monetary policies of two major central banks will be in focus this week. The attention will be on the European Central Bank's (ECB) views on the recent rise in government bond yields: whether it has tightened financial conditions and if the bank signals any intention to lean against it.

Directional views

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

Change in view
Previous New

Asset	Strategic view	Tactical view	
Equities	**Neutral**	**+1**	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We tilt toward EM equities. Tactically, we have upgraded equities to overweight as we expect the restart to re-accelerate and rates to stay low. We like a barbell approach: quality stocks balanced with selected cyclical exposures.
Credit	**Neutral**	**+1**	We are 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 see the economic restart and ongoing policy support helping credit perform, even amid tighter yield spreads and the wind-down of some emergency credit support.
Govt bonds	**-1**	**Neutral**	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 policy accommodation suppresses yields.
Cash		**Neutral**	We are neutral and use cash to fund overweights in equities and credit. Holding some cash makes sense, in our view, as a buffer against the risk of supply shocks that could drive both stocks and bonds lower.
Private markets	**Neutral**		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 not suitable for all investors.

Note: Views are from a U.S. dollar perspective, December 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, December 2020

	Asset	Underweight	Overweight	
Equities	United States			We have upgraded U.S. equities to overweight. We see the tech and healthcare sectors offering exposure to structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
	Euro area			We have downgraded European equities to underweight. The market has relatively high exposure to financials pressured by low rates. It also faces structural growth challenges, even given potential for catch-up growth in a vaccine-led revival.
	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
	Emerging markets			We are overweight EM equities. We see them as principal beneficiaries of a vaccine-led global economic upswing in 2021. Other positives: our expectation of a flat to weaker U.S. dollar and more stable trade policy under a Biden administration.
	Asia ex-Japan			We are overweight Asia ex-Japan equities. Many Asian countries have been more effective at containing the virus – and are further ahead in the economic restart. We see the region's tech orientation allowing it to benefit from structural growth trends.
	Momentum			We keep momentum at neutral. The factor could face challenges in the near term as a resurgence in Covid-19 cases and risks of fading fiscal policy support create potential for choppy markets.
	Value			We are neutral on value. The factor could benefit from an accelerated restart, but we believe that many of the cheapest companies – across a range of sectors – face structural challenges that have been exacerbated by the pandemic.
	Minimum volatility			We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
	Quality			We are overweight quality. We like tech companies with structural tailwinds and see companies with strong balance sheets and cash flows as resilient against a range of outcomes in the pandemic and economy.
	Size			We are overweight the U.S. size factor. We see small- and mid-cap U.S. companies as a key place where exposure to cyclicality is likely to be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields as staying rangebound, but real yields declining amid rising inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
	Treasury Inflation-Protected Securities			We are overweight TIPS. We see potential for higher inflation expectations to get increasingly priced in on the back of structurally accommodative monetary policy and increasing production costs.
	German bunds			We are neutral on bunds. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
	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 have downgraded investment grade credit to underweight. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
	Global high yield			We have trimmed our overweight in global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency			We have upgraded hard-currency EM debt to neutral. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			We have upgraded local-currency EM debt to neutral. We see catch-up potential as the asset class has lagged the risk asset recovery. Easy global monetary policy and a stable-to-weaker U.S. dollar should also underpin EM.
	Asia fixed income			We are overweight Asia fixed income. We see the asset class as attractively valued. Asian countries have done better in containing the virus and are further ahead in the economic restart.

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