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Weekly commentary

BlackRock.

March 29, 2021

Why we still like technology stocks

- The recent government bond yield spike has pressured tech stocks, yet we are still constructive on technology both on tactical and strategic horizons.
- The Federal Reserve made clear its intent to stay behind the curve on inflation, keeping short-term rates low for longer than they would have in the past.
- Investors will focus on U.S. nonfarm payrolls data this week to gauge the restart in the labor market.

The recent bond yield spike has been blamed for pressuring tech stocks as they are seen as vulnerable to rising rates. We believe this view is too simplistic: tech is a diverse sector and the *driver* of higher yields matters more than the rise itself. Our *new nominal* theme implies central banks will be slower to raise rates to curb inflation than in the past, supporting our pro-risk stance and preference for tech.

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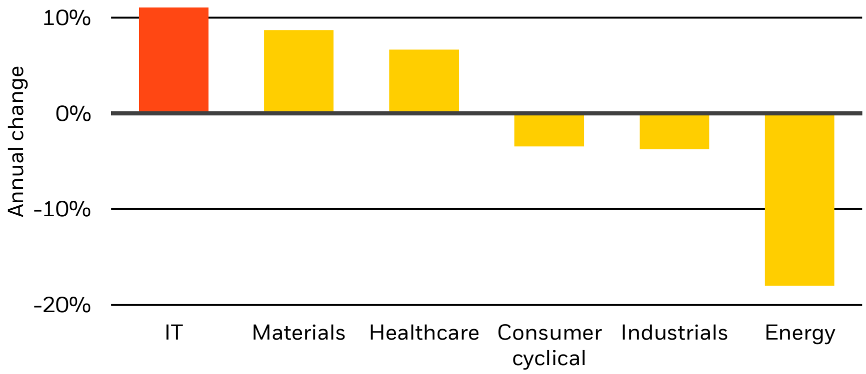
Chart of the week

Annualized five-year trailing earnings growth in selected sectors



Sources: BlackRock Investment Institute, with data from Refinitiv, March 2021. Notes: The chart shows the three sectors on the MSCI World Index with the highest annualized earnings growth over the past five years, and the three sectors with the biggest annualized earnings decline for the same period.

Many tech stocks have fallen out of favor recently despite strong earnings. Over the past month information technology has been the worst-performing sector on the MSCI World Index, down 2% versus a flat broader market – after a year of strong performance. Tech's underperformance since mid-February has coincided with a rise in the U.S. 10-year Treasury yield to a 14-month high, yet we believe the sector's vulnerability to higher yields is overstated (more on that later). The sector has delivered the best earnings over the last five years on the MSCI World Index, as the chart shows. Looking ahead, we still see long-term trends including digitalization and a "green" transition to a low-carbon economy as supportive of the sector, even as more cyclical sectors may deliver much stronger earnings growth in the near term amid the economic restart. It's important to recognize the IT sector as defined by the GICS – a widely used industry classification system – covers software and services, tech hardware and equipment, and semiconductors and equipment – but not online search and ecommerce giants.

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Rising yields are in theory bad for tech stocks with high growth expectations: it reduces the present value of their long-dated cash flows. Yet simply concluding that higher 10-year yields are bad for tech misses a crucial part of the story – the key is what is driving those yields higher, in our view. A sharp rise in yields across the curve – reflecting an upward shift in the Fed's expected policy path – would hit equity valuations. But instead, the recent yield spike has been driven by an increase in the term premium– the excess yield investors demand over and above the expected policy path of cash rates for bearing interest rate risk. The "term premium tantrum" mostly reflects investors requiring higher compensation for the now greater risks to portfolios presented by government bonds and inflation, in our view. This makes equities even more appealing than bonds in a multi-asset context – and suggests any further sell-offs in tech may present opportunities. We believe tech companies beating earnings expectations once again will be rewarded if bond yields settle back into a range.

Yet it is important to recognize what a diverse sector tech is: The rate sensitivity for equity valuations is greatest for the highest-growth, least-profitable companies. A rotation into cyclicality amid an accelerated restart may pose a near-term challenge for some tech companies that have benefited from "work from home" and other pandemic-related trends, and benefit more cyclical tech industries, such as semiconductors. Strong pricing power due to global semiconductor supply chain disruptions and demand for consumer electronics could give it a further boost. Strategic U.S.-China competition – especially on technology – is likely to persist and could cause bouts of volatility. Yet we believe investors need exposure to both poles of growth. Tactically we are overweight U.S. and Asia ex-Japan equities partly because of the tech exposures in both. We are also overweight U.S. small caps and emerging market equities as part of our broadened pro-cyclical stance.

Regulation is a growing risk in the tech sector – and not just in Europe. This includes an anti-monopoly drive in China that threatens large-cap behemoths, and potentially a tough stance on big tech regulation and higher corporate taxes in the U.S.

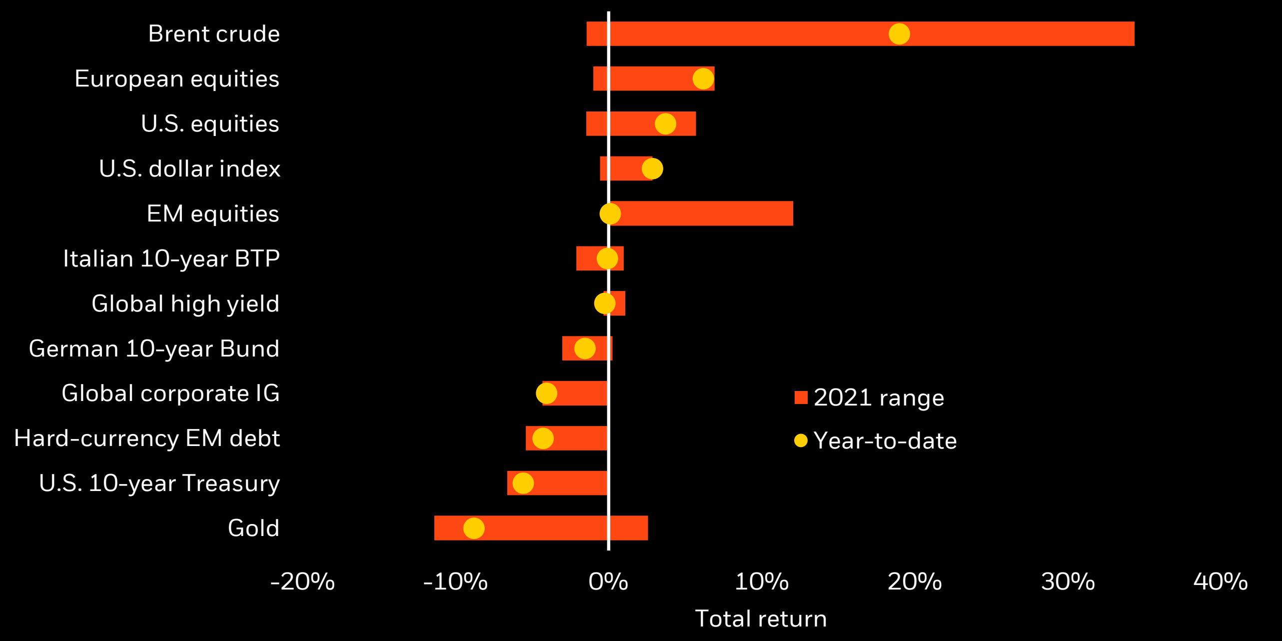
The bottom line: We maintain a positive tactical and strategic view on the tech sector. Any further "term premium tantrum" may present tactical opportunities. On a strategic basis, we see tech supported by structural growth trends – and as one of the sectors set to benefit most from the "green" transition. See our climate-aware return assumptions for more.

Market backdrop

U.S. 10-year Treasury yields have retreated from the 14-month peak hit in the previous week, after the Federal Reserve made clear its intent to be well "behind the curve" on inflation and wait to see it to materialize. The rise in Treasury yields in recent months – while quick – is so far more muted than we would have typically seen in past periods of rising inflation. This is in line with our *new nominal* theme, which we expect to support equities and risk assets on the tactical horizon.

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, March 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 Europe Index, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global High Yield Index, Refinitiv Datastream Germany 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, J.P. Morgan EMBI index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

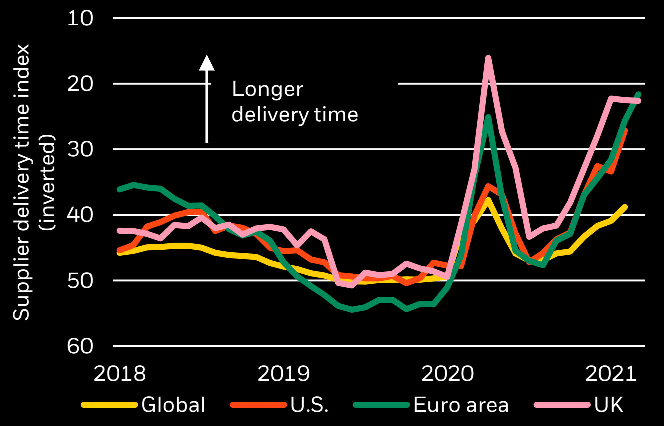
Short-term disruptions in global supply chains are likely to bring a renewed focus on inflation – and on central banks' tolerance of inflation overshoots.

Some Covid-driven supply chain disruptions are coming to the fore as pent-up demand starts to unleash amid an accelerated activity restart. The chart shows how sharply supplier delivery time has increased for manufacturing firms. The U.S. stands out for having even longer delivery time now than during the height of the pandemic.

The near-term inflation driven by supply chain disruptions is different from our expectation for higher medium-term inflation. Yet these pressures will likely further fuel the debate around the risks of an inflation regime shift and the need to add portfolio protection. Fed Chair Jerome Powell has made clear the central bank's intention to stand pat in the face of rising inflation, reinforcing our belief that we will move to a higher inflation regime in the medium term. See our macro insights hub.

Supply chain pressures

PMI supplier delivery index, 2018-2021



Sources: BlackRock Investment Institute, Markit, with data from Refinitiv Datastream and Haver Analytics, March 2021. Notes: The chart shows an index of delivery time for items used in the production process, for manufacturing firms. As delivery time lengthens – for example due to capacity constraints – the level of the index falls. The y-axis is inverted.

Investment themes

1 The new nominal

- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – has been confirmed by the Fed's March policy meeting. The Fed made it clear that the bar for reassessing its policy rate path was not met and that it was too soon to talk about tapering bond purchases, while embracing a material improvement in its outlook. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation and to wait to see it move above target has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **Market implication**: We favor inflation-linked bonds amid inflationary pressures in the medium term. Tactically we prefer to take risk in equities over credit amid low rates and tight spreads.

2 Globalization rewired

- Covid-19 has accelerated geopolitical transformations such as a bipolar U.S.-China world order and a rewiring of global supply chains, placing greater weight on resilience.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels and U.S.-China conflicts, but we believe investors are compensated for these risks.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like Asia ex-Japan equities, and see UK equities as an inexpensive, cyclical exposure.

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 strong performance 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 see returns being driven by climate change impacts, and view developed market equities as an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

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Week ahead

March 30	U.S. consumer confidence	**March 31**	China official purchasing managers' index; euro area inflation
April 1	U.S. ISM manufacturing PMI	**April 2**	U.S. nonfarm payrolls

U.S. nonfarm payrolls data will be in focus this week. It is expected to shed light on the status of the labor market recovery, especially in contact-intensive service sectors that have suffered most over the past year. A Reuters poll pointed to an increase of 655,000 jobs, compared with a rise of 379,000 in February. Investors will also seek to gauge the restart from PMI data from the U.S. and China.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are 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 indexes. 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 bias for quality.
Credit	-1	Neutral	We are underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, credit, especially investment grade, has come under pressure from tightening spreads, but we still like high yield for income.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and 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 as we see risks of higher inflation in the medium term. We are underweight duration on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart.
Cash		Neutral	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.
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 not suitable for all investors.

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

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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, March 2021

	Asset	Underweight	Overweight	
Equities	United States			We are overweight U.S. equities. 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.
Equities	Euro area			We are neutral European equities. We believe the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
Equities	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
Equities	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.
Equities	Asia ex-Japan			We are overweight Asia ex-Japan equities. Many Asian countries have effectively contained 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.
Equities	UK			We are overweight UK equities. The removal of uncertainty over a Brexit deal should see the risk premium on UK assets attached to that outcome erode. We also see UK large-caps as a relatively attractive play on the global cyclical recovery as it has lagged peers.
Equities	Momentum			We keep momentum at neutral. The factor has become more exposed to cyclicality, could face challenges in the near term as a resurgence in Covid-19 cases and a slow start to the vaccination efforts create potential for choppy markets.
Equities	Value			We are neutral on value despite recent underperformance. 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.
Equities	Minimum volatility			We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol has historically lagged in such an environment.
Equities	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.
Equities	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 may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields rising but largely due to a repricing higher of inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Euro area peripherals			We are neutral euro peripheral bond markets. Yields have rallied to near record lows and spreads have narrowed. The ECB supports the market but it is not price-agnostic - its purchases have eased as spreads have narrowed.
Fixed Income	Global investment grade			We are underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
Fixed Income	Global high yield			We are moderately overweight global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
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. 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.
Fixed Income	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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