Weekly commentary

BlackRock.

June 1, 2021

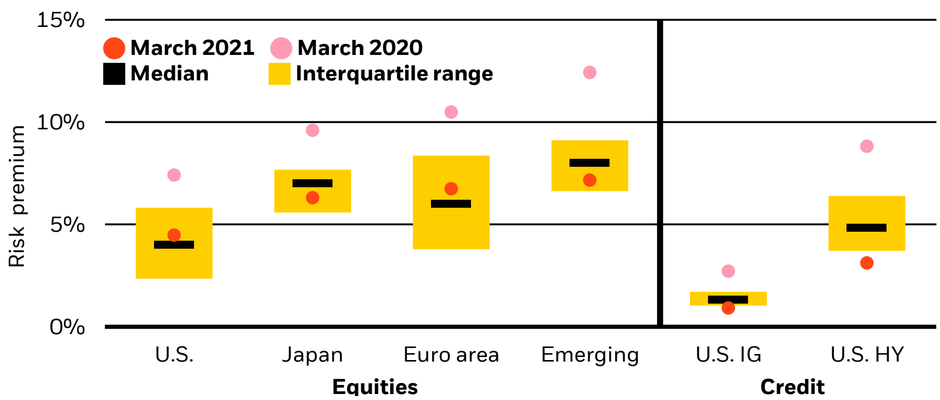
Policy revolution's long reach

- A lower future path of short-term rates even as inflation outpaces market expectations underpins our strategic preference for equities over bonds.
- U.S. government bond yields dropped to the lowest level since early May; Fed officials reiterated the transitory nature of the ongoing inflation spike.
- U.S. nonfarm payrolls will be in focus after much weaker-than-expected April data, highlighting volatile near-term data amid the economic restart.

The powerful policy revolution implies a lower future path of interest rates than markets are pricing in, even amid rising inflation over the medium term, as captured in our *new nominal* investment theme. Lower rates – even compared to our previous expectations – lift our expected returns across asset classes over the strategic horizon, and reinforce our preference for equities over bonds.

Chart of the week

Equity risk premium and credit spread current vs. historical



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. You cannot invest directly in an index. Sources: BlackRock Investment Institute and Refinitiv Datastream, data as of March 2021. Notes: The chart shows the equity risk premium and historical ranges since 1995 for major equity regions based on MSCI indexes and the credit spreads for the U.S. investment grade and high yield markets based on Bloomberg Barclays indexes. We calculate the equity risk premium based on our expectations for nominal interest rates and the implied cost of capital for respective equity markets. Credit spreads are calculated by taking the difference between the credit market yields and the corresponding government bond yields.

Both equities and credit have rallied strongly since March 2020, yet we still see equities as reasonably valued, while credit spreads are close to their tightest levels relative to history. We see the equity risk premium (ERP) – our preferred gauge of equity valuations that accounts for changes in interest rates – as in-line with historical averages, suggesting the asset class is not overvalued. See the chart above. The improving corporate earnings outlook has offset some of the impact of rising equity prices on valuations. The result? The ERP still remains above its historical median for the U.S. and euro area, bolstering their relative appeal. Our *new nominal* theme sees a lower path of short-term interest rates compared with our previous expectations and current market pricing, further supporting our estimates of the ERP today. The policy revolution also indicates a steeper yield curve than we have previously forecasted – and important implicit limits on how high government bond yields may go over the next five years, in our view.

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BlackRock **Investment** Institute

We have updated our long-term return assumptions to fully incorporate the *new nominal* theme and broader implications of the policy revolution, and to reflect changes in market prices and fundamentals. Our non-consensus inflation outlook is key. We see higher medium-term inflation, due to rising production costs, the Federal Reserve's new policy framework to allow inflation overshoots, and rising debt levels that will make it harder for central banks to lean against inflation. As a result, we believe markets are still underestimating inflation risk in the medium term.

Long-term U.S. government bond yields have risen this year, but the rise has been more muted than typically seen in response to rising inflation and growth expectations in the past. We believe the spike in bond yields earlier in the year was driven by a higher term premium – or the premium investors typically demand to hold riskier long-term government bonds – rather than expectations for higher policy rates. We don't see it as threatening the broad equity market – particularly against the backdrop of economic restart – but could lead to leadership changes within equities. We believe a "term premium tantrum" - or an unexpected increase in term premium from here – would ultimately reduce the attractiveness of fixed income but reinforce that of equities.

Keeping yields low enough to ensure the viability of surging debt burdens in the developed world and stability in emerging markets is an important interaction between fiscal and monetary policy that informs our views. We ultimately expect yields to rise over the strategic horizon, but see important limits on the level of yields that the economy can withstand. We estimate if the 10-year Treasury yield rose to 2.5% or higher, debt servicing costs would exceed the 50-year average share-to-GDP of 2% as estimated by the Congressional Budget Office. Over the longer term, fiscal sustainability concerns could lead investors to demand greater compensation for holding government bonds relative to holding cash – and our updated assumptions feature steeper yield curves in the future to reflect this. Both factors reinforce our strategic underweight on developed market (DM) nominal bonds.

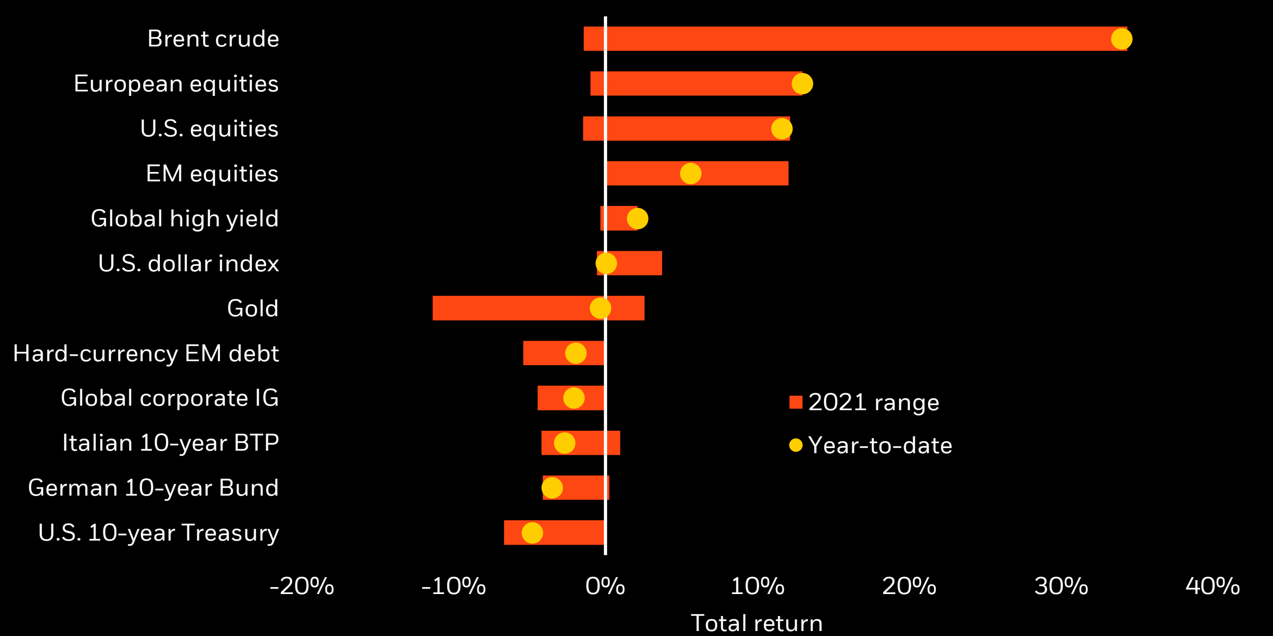
The bottom line: We prefer equities over credit and government bonds on a strategic horizon. Within equities we like DM and China, helped in part by the impact of incorporating climate change in our return expectations. We prefer inflation-linked bonds to nominal bonds as portfolio ballast.

Market backdrop

U.S. government bond yields dropped to the lowest level since early May and stocks held steady; Fed officials reiterated the transitory nature of the ongoing inflation spike. Economic data have been erratic, and we expect more of the same as economies restart amid pent-up consumer demand and supply shortages. We advocate looking through near-term market volatility and remain pro-risk, predicated on our belief that the Federal Reserve faces a very high bar to divert from its new policy framework to keep yields low.

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 May 27, 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, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), spot gold, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

Macro insights

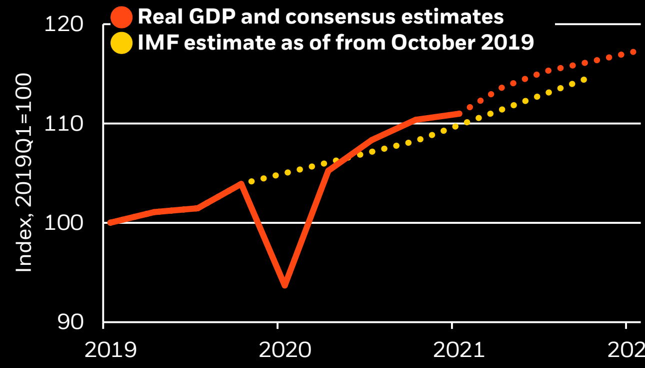
Recent softening in China's economic data should be seen in the context of overall activity levels that have already surpassed pre-Covid trend expectations. Moderating growth in China is unlikely to derail global growth momentum, in our view, as the restart broadens out in the U.S. and Europe.

China's post-Covid activity restart has been swift, as shown in the chart. GDP data for the first quarter of 2021 show that activity was already above pre-Covid trend estimates – a milestone China hit much earlier than projections for developed economies. Consensus expectations for 2022 point to a moderation in year-on-year growth rather than a material slowdown.

The rest of the world has already benefitted from China's growth spillovers. The boost has also coincided with the vaccine-led restart in domestic activity in developed economies. We see the strength in domestic business investment spending putting Western economies on a path to return to pre-Covid trends on a sustained basis. See our macro insights hub for more.

Moderating growth

China real GDP level and estimates, 2019-2022



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, Reuters Polls, IMF, with data from Haver Analytics, May 2021. Notes: The chart shows the actual and estimated real GDP for China, indexed to 100 in the first quarter of 2019. The solid orange line shows the path of actual real GDP and the dotted orange line shows consensus expectations of real GDP according to the latest Reuters poll. The dotted yellow line shows the level of estimated GDP according to the IMF's October 2019 World Economic Outlook.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart – with the euro area catching up - powered by pent-up demand and sky-high excess savings. The huge growth spurt will be transitory, in our view. This is because a restart is not a recovery: the more activity restarts now, the less there will be to restart later.
- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – was confirmed by the Fed's recent policy meetings. 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. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation has helped the Fed regain control of the narrative – for now.
- We believe the rise in nominal government bond yields this year is justified and reflects markets awakening to a strong, vaccine-driven activity restart combined with historically large fiscal stimulus.
- 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. Pending legislation in the U.S. would direct large-scale investment to meet the China challenge. We see a case for greater exposure to China-related assets for potential returns and diversification – and view them as core strategic holdings that are distinct from EM exposures.
- 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.
- Momentum is growing at the G20 for a global minimum tax that would reduce the ability of multinationals to shift profits to low-tax jurisdictions.
- **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. We see a risk of social unrest.
- **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.

Week ahead

May 31	China official manufacturing purchasing managers' index (PMI)
June 1	Manufacturing PMI for Japan, China (Caixin), the euro area, the UK and U.S. (ISM); euro area flash inflation
June 3	IHS Markit services PMI for Japan, China (Caixin), the euro area and UK; U.S. ISM services PMI
June 4	U.S. nonfarm payrolls, factory orders

Markets will be focused on the U.S. nonfarm payrolls data this week. April's payrolls fell far short of expectations, highlighting the challenge of forecasting month-on-month changes as the unusual supply and demand dynamics amid the powerful economic restart lead to volatile data. Consensus forecast points to a 650,000 increase in May, after a 266,000 increase in the previous month.

Directional views

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

Asset	Strategic view	Tactical view	Change in view: Previous → New
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, May 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, May 2021

	Asset	Underweight	Overweight	
Equities	United States		Overweight	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.
	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.
	Japan	Underweight		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.
	Emerging markets		Overweight	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		Overweight	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.
	UK		Overweight	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.
	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.
	Value			We are neutral on value despite recent outperformance. 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.
	Minimum volatility			We turn neutral min vol. Our regional and sectoral preferences warrant a higher exposure to the factor. Min vol's underperformance has brought valuations to more reasonable levels in our view.
	Quality		Overweight	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		Overweight	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	Underweight		We are underweight U.S. Treasuries. The accelerated economic restart has sent yields surging, but we prefer to stay underweight as we expect short-term rates will stay anchored near zero.
	Treasury Inflation-Protected Securities			We are neutral TIPS after the sharp rise in inflation expectations since late year. Further increases seem unlikely in the near-term. We still see inflation pressures building over the medium term due to structural reasons.
	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 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.
	Global investment grade	Underweight		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.
	Global high yield		Overweight	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.
	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.
	Emerging market – local currency		Overweight	We are overweight EM local debt as its year-to-date underperformance has left valuations more appealing, particularly if U.S. Treasury yields and the U.S. dollar stabilize. We see limited contagion to broader EM from selected country-specific volatility.
	Asia fixed income		Overweight	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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