

Weekly commentary

July 12, 2021

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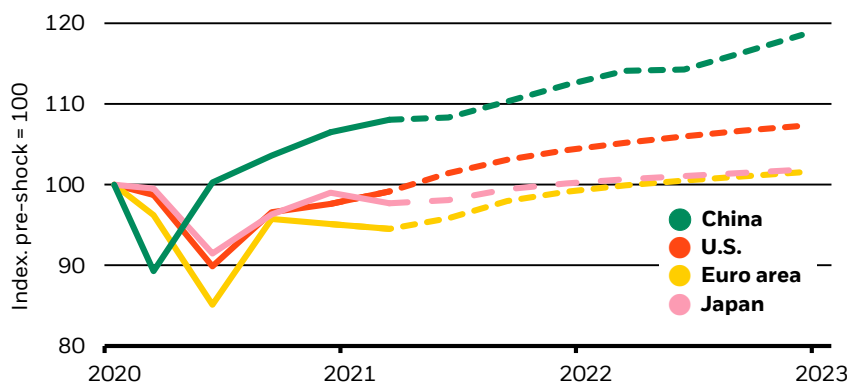
Looking through near-term volatility

- A wide range of potential economic outcomes beyond the restart has left markets prone to volatility, but we remain pro-risk and lean into cyclical.
- U.S. stocks rallied to record highs after selling off earlier last week. China unexpectedly loosened its monetary policy to support economic growth.
- Investors will watch China's activity data for signs of slower growth; U.S. consumer inflation data will also be in focus.

Investors are contemplating very different potential outcomes beyond the economic restart – leaving markets prone to overreacting to news flow, as we witnessed just last week. We see holding on to a clear medium-term anchor as crucial. *The new nominal* – a more muted monetary policy response to inflation than in the past – is for us such an anchor, and supports our pro-risk stance.

Broadening restart

Estimated GDP path for key economies, July 2021



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Eurostat, Cabinet Office of Japan, China National Bureau of Statistics, with data from Refinitiv Datastream and Reuters News, July 2021. Notes: The chart shows actual GDP, and projections of GDP levels in different economies according to latest consensus estimates compiled by Reuters, with data rebased to 100 in Q4 2019. Solid lines represent published GDP data, and dotted lines show median consensus expectations.

The powerful restart is broadening, as we detailed in our [2021 midyear outlook](#). China's activity levels already surpassed pre-Covid trend estimates within 2020. We see U.S. activity now back above pre-Covid levels, and restart momentum is now picking up in the euro area and Japan. See the chart above. We see the post-pandemic world as very different from the recovery after the global financial crisis that featured deleveraging, sluggish growth, low inflation and constant policy support. That support helped herald a decade-long bull market in both risk assets and bonds. By contrast, historic fiscal stimulus and innovative monetary policy in response to the Covid-19 shock make a repeat of the 10-year bull market in stocks and bonds unlikely, in our view. Our base case is *the new nominal*: We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past. This should be positive for equities and neutral for bonds, in our view. Yet we also see the potential for other macro outcomes. In such a noisy and unprecedented economic restart, volatile data and market over-reactions are to some extent expected, in our view.



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BlackRock Investment Institute

The new nominal is one of our three themes, along with *China stands out* and the *journey to net zero*. It is key to our tactical pro-risk stance and supports our strategic preference for equities over credit and bonds. Tactically we see potential for cyclical shares and regions to benefit from the broadening restart. We are turning positive on European equities – after having upgraded it to neutral earlier in the year when sentiment on this market was negative – and upgrading Japanese equities to neutral. Strategically we see the equity risk premium – our preferred gauge of equity valuations that accounts for interest rate changes – as in line with historical averages. This suggests equities are not overvalued, while credit spreads are near historically tight levels. We also see private market valuations supported in such an environment.

Our second theme – *China stands out* – stems from our belief it is time to treat China as an investment destination separate from emerging markets (EM) and developed markets (DM) as it is already a distinct pole of global growth. China's central bank last week announced a decision to cut the reserve requirement ratio, or the amount of cash banks must hold as reserves, to support economic growth that appears to be losing steam. This came sooner than we had expected, yet we still believe the government will maintain its broadly hawkish policy preference to stay focused on the quality of growth. Together with the ongoing anti-monopoly clampdown, this supports our tactically neutral view on China equities and overweight on China bonds. We are positive on Chinese equities and government bonds on a strategic basis.

The *journey to net zero* is our third theme. We believe markets are underappreciating the profound changes coming, and the transition to net zero carbon emissions will create opportunities across investment horizons. Certain commodities, such as copper and lithium, will likely see increased demand along the journey, in our view. Yet we think it's important to distinguish between the near-term drivers of commodity prices – such as the powerful restart – and the net-zero transition that will have implications on prices over the long term. Our climate-aware return assumptions sees a green transition to a low-carbon economy improving the outlook for growth and risk assets relative to a no-action scenario.

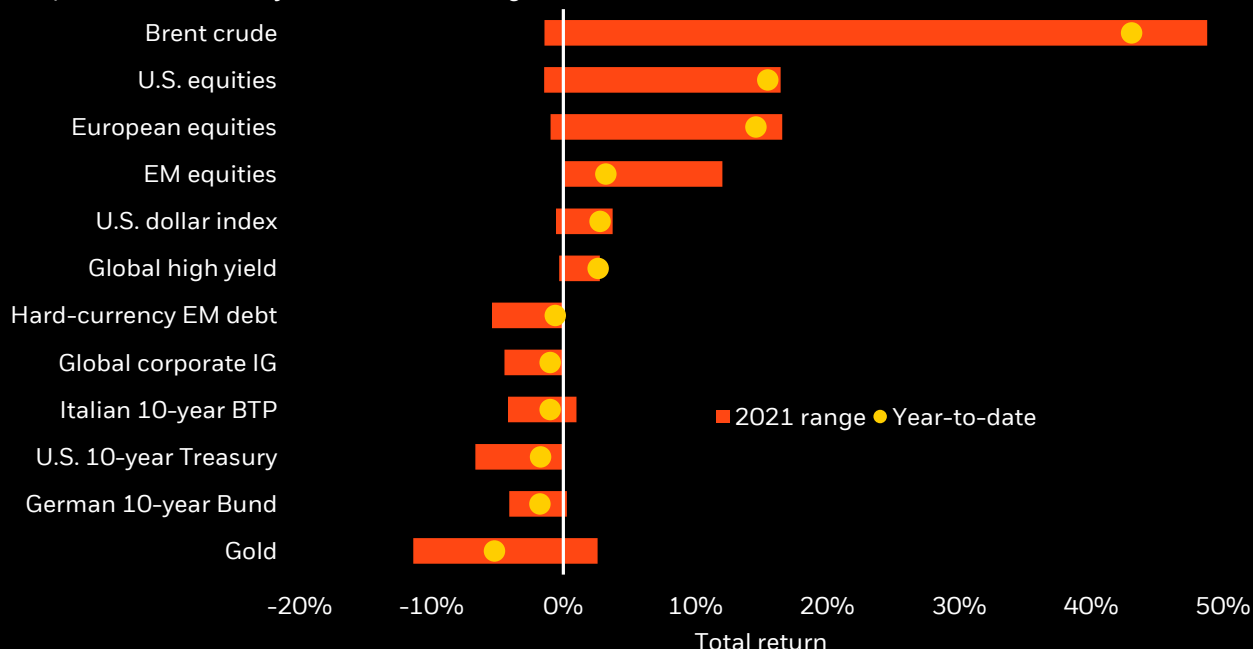
The bottom line: Investors shouldn't be surprised by any near-term market whipsaw as volatility is expected to some extent under the unprecedented restart dynamics. We favor equities over credit and government bonds on both a strategic and tactical horizon, informed by our three investment themes. Read details in our [2021 midyear outlook](#).

Market backdrop

U.S. stocks rallied to record highs after selling off earlier in the week. U.S. government bond yields declined. In a noisy and unprecedented economic restart, volatility in data and market reaction is to some extent expected, in our view. China's central bank unexpectedly announced a decision to cut the reserve requirement ratio, or the amount of cash banks are required to hold as reserves, effective on July 15. Yet we still believe the government will maintain its broadly hawkish policy preference as it focuses on the quality of growth.

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 July 8, 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, MSCI Emerging Markets Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield IG, 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 U.S. 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and spot gold.

Macro insights

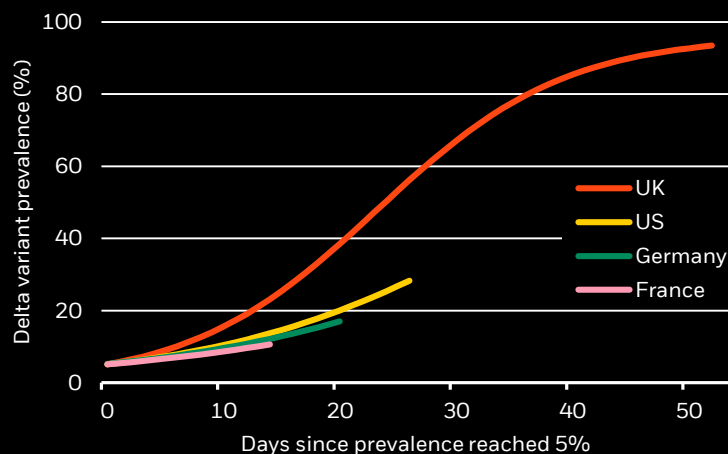
The spread of the highly transmissible Delta variant has caused renewed Covid-19 flare-ups around the world. In the UK, the variant already accounts for nearly 100% of infections and cases are still growing. Yet the advanced vaccine rollout appears to have weakened the link between cases and hospital admissions, allowing reopening to continue after a one-month delay.

In the U.S. and continental Europe, the Delta variant will likely reach peak transmission through the summer. Evidence so far suggests the spread in these regions may be less rapid than in the UK; we see vaccines similarly limiting hospitalizations. See the chart. We might see some delays in reopening, but we do not expect the restart to be derailed given the vaccine's effectiveness.

Studies so far have shown that two doses of the vaccines have greater than 90% efficacy against hospitalization from the Delta variant. This supports our view of a broadening global economic restart. See our [macro insights](#) hub.

Delta's different paces

Estimated Delta variant prevalence in different countries, July 2021



Sources: BlackRock Investment Institute, with data from Outbreak.info. Notes: The chart shows the percentage of new sequenced cases attributed to the Delta variant, starting on the day where prevalence reached 5%.

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. The market's lack of confidence in the Fed's commitment to its new framework poses a risk of tighter financial conditions in the near term. We would anticipate this uncertainty to dissipate over time – assuming the central bank regains control of its narrative – paving the way for us to lean even more tactically pro-risk.
- The European Central Bank has set its inflation target at 2% in the medium term but rejected an average inflation targeting framework. We see this as part of an ongoing policy evolution, and see near-term policy changes as unlikely. The ECB also said it would include climate change considerations in monetary policy operations.
- **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. Growth in China is starting to slow at the same time the policy stance is relatively tight. The regulatory crackdown on dominant companies is ongoing. We see these as key aspects of China's efforts to improve the quality of growth.
- China's central bank unexpectedly announced a decision to cut the reserve requirement ratio, or the amount of cash banks must hold as reserves, to support economic growth that appears to be losing steam. We still believe the government will maintain its broadly hawkish policy preference to stay focused on the quality of growth.
- We could see times when markets become concerned that China's policy setting might be excessively tight. That points to downside risks in the short term. China is pushing through reforms that could weigh on the quantity of growth in the near term but potentially improve the *quality* in the long run.
- **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

July 13

U.S. consumer price index; China trade data

July 16

Euro area inflation; U.S. retail sales, Univ. of Michigan Surveys of Consumers; Bank of Japan policy meeting



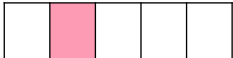

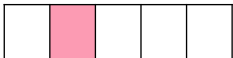
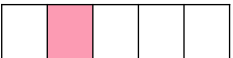


July 15

China industrial output, retail sales and GDP

Investors will focus on a number of activity indicators for China and U.S. consumer inflation data. We will watch for signs of a slowdown in China's data after the economy has come through the Covid-19 shock stronger than global peers. U.S. inflation is likely to remain high, even if price pressures brought on by the restart dynamics may ultimately prove to be transitory.

Directional views

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

Asset	Strategic view	Tactical view	Change in view Previous → New
Equities	 +1	 +1	<p>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 cyclical and maintain a quality bias.</p>
Credit	 -1	 Neutral	<p>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.</p>
Govt bonds	 -1	 -1	<p>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.</p>
Cash		 Neutral	<p>We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.</p>
Private markets	 Neutral		<p>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.</p>

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

Asset	Underweight	Overweight	
Equities			United States
			U.S. small caps
			Europe
			UK
			Japan
			China
			Emerging markets
			Asia ex-Japan
Fixed Income			U.S. Treasuries
			Treasury Inflation-Protected Securities
			German bunds
			Euro area peripherals
			China government bonds
			Global investment grade
			Global high yield
			Emerging market – hard currency
			Emerging market – local currency
			Asia fixed income

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