Weekly commentary

March 23, 2020

BlackRock

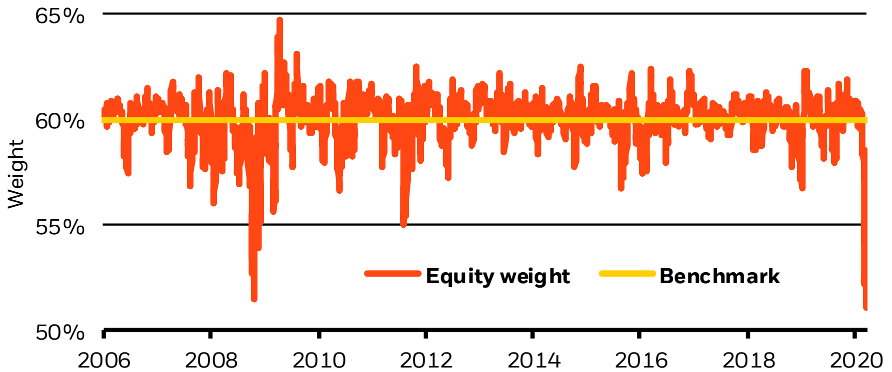
A rebalancing act

- Recent sharp market moves may have pushed many portfolios off their strategic allocations. We see room to rebalance toward benchmarks.
- Fiscal and monetary policy action to bridge the impact of the coronavirus is starting to take shape – and may be underappreciated.
- A virtual summit by the Group of 20 economies could signal more concrete policy cooperation needed to deal with the virus shock.

Drastic market moves in recent weeks – triggered by fears of the coronavirus outbreak and its economic toll – have likely thrown many portfolios off their broad asset class benchmark weights. Sharp equity selloffs and government bond yield declines have mechanically turned many portfolios underweight equities and overweight bonds. We favor rebalancing toward benchmark weights, but recognize that timing and implementation will vary by investor.

Chart of the week

One-month drift from equity benchmark in a 60/40 portfolio, 2006-2020



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream , March 2020. Notes: The chart shows the rolling one-month move away from the benchmark weight of equities in a hypothetical 60/40 portfolio of 60% equities and 40% bonds. We use the MSCI World Index and Bloomberg Barclays Global Aggregate Bond Index to represent the two asset classes.

Many investors rebalance portfolios back toward strategic benchmarks on a calendar basis. Yet extreme market moves have likely caused their portfolios to drift dramatically from benchmarks. We illustrate with a hypothetical portfolio of 60% developed market equities and 40% global bonds. Over the past month, the weight of equities in the portfolio would have rapidly shrunk to just over 50% due to a sharp equity selloff. This one-month drift has been sharper than that seen during the 2008 crisis. See the chart above. We still see benchmark weights as appropriate. This implies a need to rebalance portfolios – effectively buying equities and selling bonds. To be sure, we believe it is too soon to overweight equities. As we await signs coronavirus infections are peaking and decisive policy actions are stabilizing the economy and markets, it may be prudent to start leaning against market moves through rebalancing. The right time to do so will vary by investor, and should take into account considerations such as transaction costs and market liquidity.

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BlackRock **Investment** Institute

The coronavirus outbreak represents a major external shock to the macro outlook, akin to a large-scale natural disaster. Public health measures deployed to stop the virus' spread are set to bring economic activity to a near standstill and cause a sharp contraction in economic growth in the second quarter. But we expect activity to ultimately return with limited permanent damage as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock.

The required policy response includes drastic public health measures to stem the outbreak – and a decisive, pre-emptive and coordinated policy response to stabilize economic conditions and financial markets. All this is starting to take shape. Central banks have cut rates and adopted measures to ensure markets keep functioning. The key here is to alleviate any dysfunction of market pricing and tightening of financial conditions. What is needed are overwhelming and coordinated policies – both on monetary and fiscal fronts – that forestall any cashflow crunches, especially among small businesses and households, that could lead to financial stresses and tip the economy into a crisis, as we detail in Time for policy to go direct. The UK, Canada and Australia have served as models of policy coordination, as we have advocated in Dealing with the next downturn. We expect a third, significantly larger, fiscal package to emerge soon in the U.S. – likely reaching $1 trillion, or 5% of GDP – although there may be twists and turns as it makes its way through Congress.

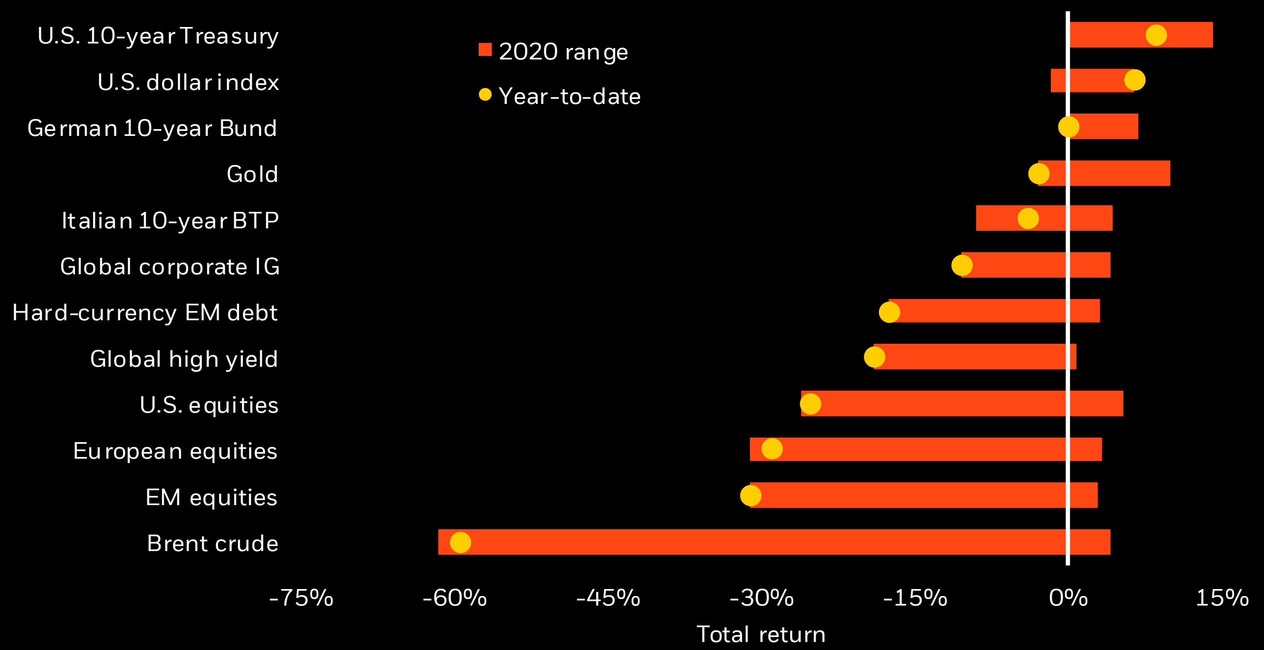
We maintain benchmark weight in equities, credit, government bonds and cash, but have updated our granular asset allocation views for the next six- to 12-months. We emphasize geographies with the most policy space – such as the U.S. and China in both equities and credit, and favor quality exposures. We upgrade U.S. equities because of their quality bias and expected support from fiscal stimulus. We downgrade Japanese equities because of the limited monetary and fiscal policy space to offset the outbreak's impact. In fixed income, we reduce Treasury Inflation-Protected Securities (TIPS) to neutral after a huge decline in rates, though we still see value in the long term. We upgrade euro area peripheral government bonds to neutral after the recent spread widening and an expectation that measures by the European Central Bank will keep yields low in southern-tier countries. For long-term investors, significant value has been created in risk assets.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus is starting to take shape as the outbreak and related containment measures propagate across the globe. The policy response has been swift – and we expect total fiscal stimulus to exceed that seen during the global financial crisis. We believe market volatility is distracting from the sheer amount of stimulus being put in place – and there is more to come.

Assets in review

Selected asset performance, 2020 year-to-date and range



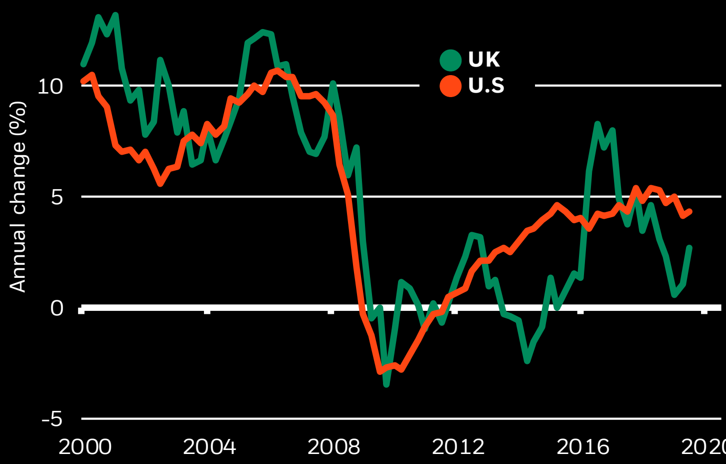
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, and the dots represent 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: spot Brent crude, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

Macro insights

The coronavirus shock has cast a spotlight on the availability and cost of funding for corporates, especially in the U.S. and Europe – with echoes of the 2008 crisis. But this is not 2008, in our view – for corporate credit or the global economy more broadly. The widening of spreads during the global financial crisis reflected concerns about the sustainability of corporate borrowing – stresses generated inside the financial system by excessive credit growth. In contrast, the credit market selloff of the past week stemmed from the coronavirus outbreak and the plunge in oil prices after the breakdown between OPEC and Russia talks on production. The backdrop for corporate credit is stronger than it was in the run-up to the financial crisis. Corporate non-financial credit growth in the U.S. has been stable over the past few years – and well below the rates seen before the financial crisis. Growth in the UK has been more subdued, though more volatile than it was in the past. But there are pockets of concern, such as leveraged loans.

Corporate credit watch

U.S. and UK non-financial corporate credit growth, 2000-2020



Sources: BlackRock Investment Institute and the Bank of International Settlements, with data from Refinitiv Datastream , March 2020. Notes: The chart shows annual private non-financial credit growth for the U.S. (orange line) and the UK.

Investment themes

1 Activity standstill

- Public health measures to combat the coronavirus outbreak are set to bring economic activity to a near standstill and cause a sharp contraction in economic growth in the second quarter.
- We expect activity to ultimately return with limited permanent damage as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock.
- The U.S. will likely prove more resilient because of a smaller share of manufacturing in its GDP, a relatively high share of healthcare spending and a pledged aggressive policy response.
- We expect a recovery in activity once disruptions dissipate, but their depth and duration are highly uncertain. This could weigh on consumption and investment.
- The main risk to our view: a broadening of the outbreak is not met with a decisive policy response, causing lasting damage to the economy.
- **Market implication**: We are sticking to benchmark holdings on an asset class level and favor rebalancing into the risk asset decline.

2 Bold policy action

- The pledged policy response has been swift – and we expect total fiscal stimulus to be similar in size to that of the financial crisis but in a shorter timeframe. Yet the swift action has been underappreciated by markets.
- Fiscal policy is the frontline of policy action and should focus on boosting public health measures and alleviating potential cash flow crunches through liquidity bridges. The European Union has pledged 1% of GDP, with individual countries signaling larger amounts and financial guarantees ranging from 10% of GDP to unlimited liquidity support. The UK, Canada and Australia have served as models for coordination between fiscal and monetary policy.
- U.S. officials went from talk of minimal stimulus to more than $1 trillion – or about 5% of GDP. The emerging plans call for measures we had advocated: "going direct", or relieving the cash flow pressures facing households and businesses – especially smaller firms – with money handouts.
- The critical focus of central banks is alleviating the dysfunction of market pricing and tightening of financial conditions. The Federal Reserve has unleashed an array of liquidity and new facilities to unclog the pipes of the financial system. The European Central Bank put together a bold response after its communication mishap earlier, launching a €750 billion bond buying program. European officials may also activate the European Stability Mechanism on relaxed terms to free up even more bond-buying capacity.
- **Market implication**: Coupon income is crucial in an even more yield-starved world.

3 Resilience rules

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds. The recent bounce in Treasury yields off record lows illustrates the risk of snapbacks.
- Our preference for U.S. Treasuries and Treasury Inflation-Protected Securities as portfolio ballast mostly worked in the virus-related equity volatility, aside from a few days when stocks and bonds both declined in the market stress.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a new phenomenon that will carry a return advantage over years and decades.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

Week ahead

Mar. 23	Euro area flash consumer confidence indicator	**Mar. 25**	German ifo Business Climate
Mar. 24	Flash purchasing managers' index (PMI) for the euro area, U.S., UK and Japan	**Mar. 26**	Bank of England rate decision; video conference of European Council members

Markets will focus on the PMIs as an indicator of the short-term impact of the virus outbreak. Eyes will also be on an unprecedented virtual summit by the Group of 20 economies (G20) this week, as well as a video conference by the European Union leadership, for signs of more concrete global policy coordination that has been lacking so far.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, March 2020

Asset	Underweight	Neutral	Overweight
Equities		■	
	We previously downgraded global equities to neutral. The coronavirus outbreak is disrupting economic activity and supply chains. The outbreak also poses risks to corporate earnings, in our view. Accommodative monetary policy is a support. We now favor rebalancing back toward benchmark weights as markets fall.		
Credit		■	
	We previously cut our overall view on credit to neutral. Downside risks and increased uncertainty around the economic outlook reduce our preference for risk assets. We could also see a risk of temporary liquidity crunches. We remain neutral as coupon income is crucial in a world starved for yield, especially at a time government bond yields are hovering near record lows.		
Government bonds		■	
	We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.		
Cash		■	
	We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.		

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, 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, March 2020

	Asset	Underweight	Overweight	
Equities	United States			We have upgraded U.S. equities for their relative quality bias and our expectation of a sizable fiscal response in the weeks ahead to complement the Federal Reserve's aggressive monetary easing.
	Euro area			We have kept European equities at underweight. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade and is now the center of the virus outbreak.
	Japan			We have downgraded Japanese equities. The coronavirus shock could drag the country into a technical recession. There is limited monetary and fiscal policy space to offset the outbreak's impact
	Emerging markets			We reduced EM equities to neutral. Valuations have cheapened but the global economic slowdown and cheaper oil challenge many EM economies and the outbreak tests their public health systems.
	Asia ex-Japan			We upgraded Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
	Momentum			We recently lifted momentum to neutral. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
	Value			We recently downgraded value to underweight. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
	Minimum volatility			We recently upgraded min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
	Quality			We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income	U.S. Treasuries			We maintain U.S. Treasuries at neutral, preferring the front end of the curve. Yet we acknowledge the risk of a sharp snapback in yields from record lows.
	Treasury Inflation-Protected Securities			We have reduced TIPS to neutral. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
	German bunds			We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
	Euro area peripherals			We have upgraded euro area peripheral government bonds to neutral. We based this on cheapening valuations and the potential for expanded support from the European Central Bank.
	Global investment grade			We remain underweight. The sector looks unattractive despite a recent sharp widening in spreads, due to slowing earnings, relatively high leverage and low coupon rates.
	Global high yield			We stay overweight global HY as a source of income, despite recent underperformance. We avoid energy as a lower for longer oil price challenges the ability of issuers to refinance near-term maturities.
	Emerging market – hard currency			We have recently downgraded hard currency EM debt to neutral. We prefer to take our risk in local currency EM debt. Default risks may be underpriced.
	Emerging market – local currency			We remain overweight, despite recent underperformance driven by a stronger U.S. dollar. The asset class looks attractive with yields above 5% -- and currency depreciation appears excessive.
	Asia fixed income			We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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