Weekly commentary

BlackRock

March 30, 2020

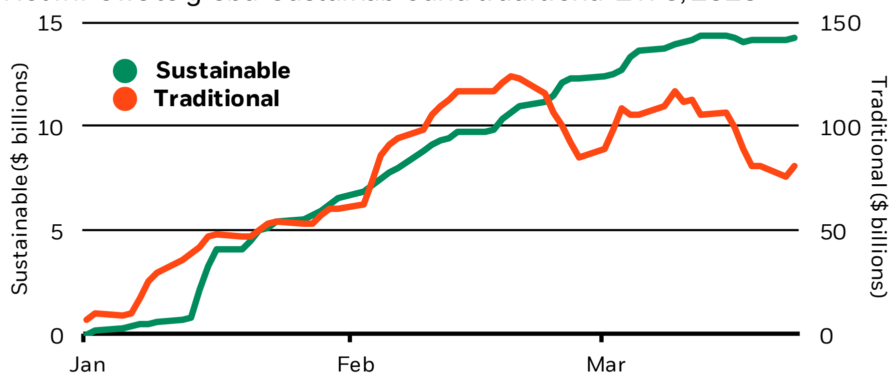
Tectonic shift to sustainable investing

- Investors should keep a long-term perspective amid market volatility, including a focus on portfolio resilience through sustainable investing.
- Historic U.S. policy actions, including over $2 trillion in fiscal support and a raft of Federal Reserve measures, helped calm markets.
- This week's data are likely to show further signs of economic damage caused by the coronavirus outbreak and containment measures.

It's important to keep a long-term perspective amid market volatility – such as the extraordinary moves of recent weeks. One enduring trend we see is a move to sustainable investing: a structural shift in investor preferences leading to large and persistent flows into assets perceived as more resilient to sustainability-related risks such as climate change. Investors rebalancing portfolios after the risk asset selloff may consider leaning into sustainable assets.

Chart of the week

Net inflows to global sustainable and traditional ETFs, 2020



Source: BlackRock Investment Institute, as of March 25, 2020. Notes: Global sustainable ETFs as any exchange-traded funds that pursue a dedicated sustainable objective, whether using a broad ESG, thematic, impact, or exclusionary strategy. Traditional ETFs are any other ETFs that are not directly focused on sustainability.

We see a sustainable investing wave playing out in financial markets over the coming decades, remaking economies and industries as capital is reallocated to sustainable assets. This year's fund flows may offer a miniature version of this shift. Sustainable exchange-traded funds (ETFs) have kept attracting assets this year, while traditional ETFs have seen heavy outflows in the market selloff. See the chart above. Net inflows into sustainable ETFs totaled $14 billion as of March 24, already more than half of 2019's full-year figure, our data showed. To be sure: The total assets under management of sustainable ETFs are just 1% of that of total ETFs, and flows to sustainable funds are still very small compared with those to traditional funds. Yet the growing interest offers a glimpse of what may lie ahead: a significant structural shift toward sustainable investing, driven by broad societal preferences. As a result, we see portfolio rebalancing in the current environment as an opportunity to substitute some traditional assets with sustainable ones, with an eye on potential long-term benefits.

Jean Boivin
Head – BlackRock Investment Institute

Brian Deese
Global Head of Sustainable Investing – BlackRock

Mike Pyle
Global Chief Investment Strategist – BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on global economy, markets, geopolitics and portfolio construction.

BlackRock **Investment** Institute

How should we expect sustainable investing strategies to perform over the long term? Skeptics have long argued the following: 1) Financial markets are efficient, so if sustainability matters it should already be reflected in market prices; 2) if investors care about sustainability, they should be willing to accept lower returns by paying a premium for "green assets"; 3) conversely, investors will earn a greater return as compensation for owning higher-risk "brown assets." This logic leads to the conclusion that we can simply ignore sustainability: Tilting toward green assets will be costly and owning brown assets will offer relatively higher expected returns. We disagree.

Why? Financial markets are imperfect at pricing information about the far-off future, even when the structural shifts are well understood. Think of slow-moving demographic trends such as population ageing and its implications for asset prices. When we complete the transition to a low-carbon economy in which sustainability will be fully embedded in marketing pricing, assets backed by high sustainability will be more expensive – while other assets will have become cheaper or disappeared altogether, in our view. Sustainable assets should earn a return benefit during the long transition to this state, in addition to greater resilience against risks such as physical disruptions from climate change. This implies the conclusion that sustainable investing requires sacrificing returns is a myth, in our view. Sustainable investing will likely carry a return advantage over years and decades, as we detail in our recent paper Sustainability: the tectonic shift transforming investing.

This phenomenon could already be playing out to some extent this year. We studied the performance of the MSCI World SRI Select Reduced Fossil Fuels Index as a proxy for sustainable global equities since late January, when China first acknowledged the coronavirus outbreak. This index outperformed its parent (MSCI World) over the period, likely due to its reduced exposure to the hard-hit energy sector. Our analysis of MSCI's back-tested data suggests the index outperformed during the market selloffs of mid-2015 and the fourth quarter of 2018. Moreover, other broad ESG equity indexes slightly outperformed their traditional counterparts in developed equity markets over the recent market plunge, we find.

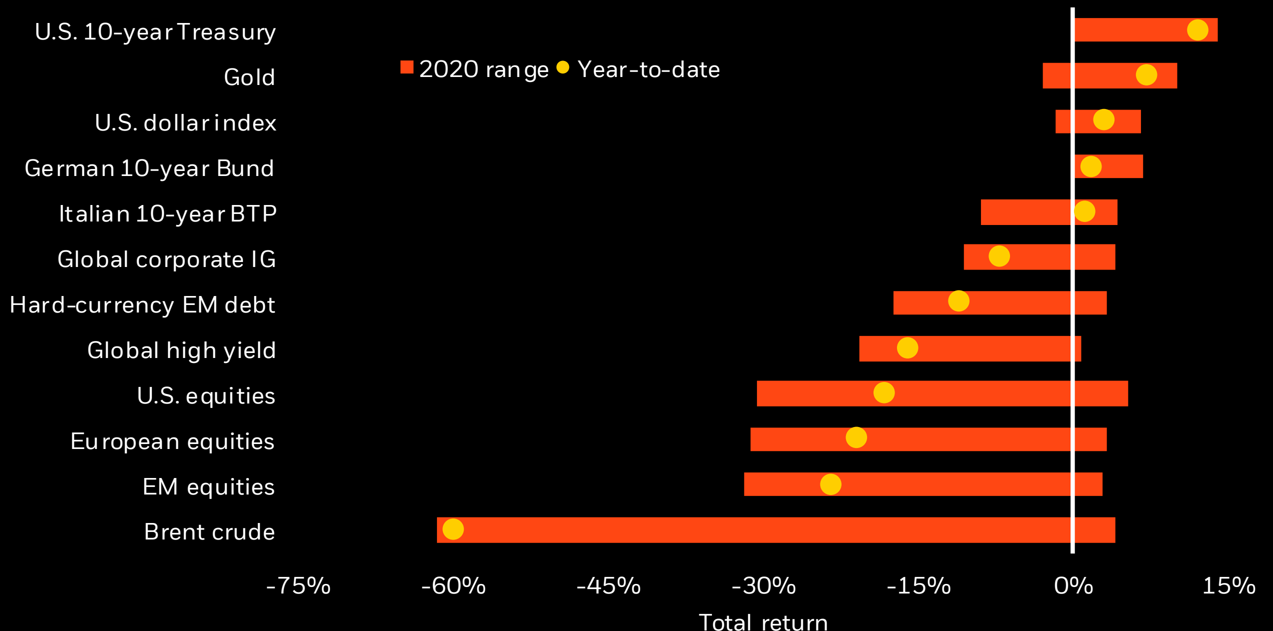
Bottom line: Flows into sustainable assets are still in their early days, and we believe that the full consequences of a shift to sustainable investing are not yet in market prices. This implies a return advantage may be gained over the long transition.

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 past week's historic U.S. policy actions initially helped stabilize markets. We believe they are paving the road for an eventual – and strong – economic and market rebound, once we better understand the scale and impact of the outbreak.

Assets in review

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



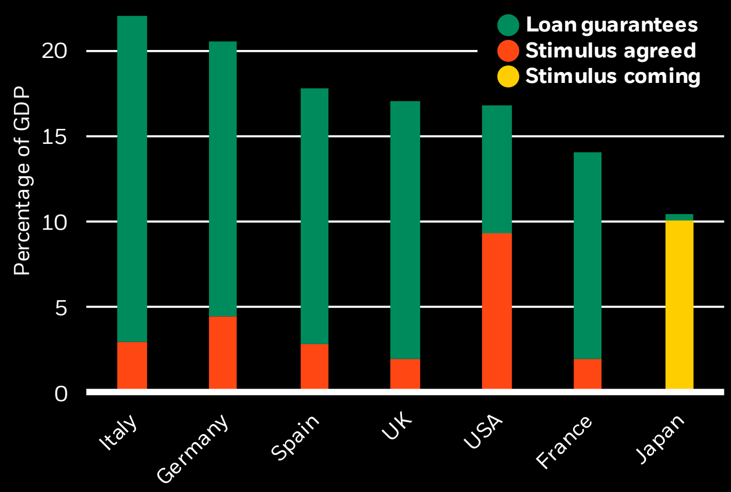
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 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

Coronavirus containment measures have slammed the brakes on economic activity. The focus is on how fiscal and monetary policy can bridge the gap left by falling private sector spending. On the back of the Federal Reserve's whatever-it-takes actions, the U.S. approved a fiscal package of 10% of GDP. A significant part of the U.S. relief package is the boost to unemployment insurance – to cover nearly 100% wage replacement for the next four months. The UK has also taken the step to cover 80% of the wage bill of furloughed workers. Germany is discussing a fiscal package of around 4.5% of GDP, including measures to make up the pay shortfall from short-time working shifts covering an expected 2.5 million workers. Italy is working on another fiscal package of about 25 billion euros, pushing its overall fiscal boost to about 3% of GDP and that of Europe overall to about 2% of GDP. And Japan is talking about fiscal relief along the lines of the U.S. – direct cash payments, SME support – at about 10% of GDP. Such measures are unprecedented in the post-World War Two era – both in size and in monetary-fiscal coordination.

Stimulus surge

Fiscal stimulus and loan guarantees as a percentage of GDP



Source: BlackRock Investment Institute, March 2020. Notes, the chart shows actual and expected stimulus measures, and actual loan guarantees, across certain developed market economies.

Investment themes

1 Activity standstill

- Public health measures to combat the coronavirus outbreak are bringing economic activity to a near standstill and look set to cause a sharp contraction in economic growth in the second quarter.
- We expect economic 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 than many other developed economies because of a smaller share of manufacturing in its GDP, a relatively high share of healthcare spending and an 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

- U.S. policymakers have announced a fiscal package of more than $2 trillion and the Federal Reserve has launched extraordinary measures to cushion the economic and market impact. The fiscal package – larger than that delivered in the global financial crisis – includes measures we had advocated: "going direct", or relieving the cash flow pressures facing households and businesses – especially smaller firms – with direct cash payments Read our bulletin on the historic policy response.
- 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 U.S response follows coordinated fiscal and monetary action in Australia, Canada and the UK, and a patchwork of fiscal relief supported by monetary policy in the euro area.
- The critical focus of central banks is alleviating the dysfunction of market pricing and tightening of financial conditions. Besides the Fed, 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. Selected equity sectors offer attractive dividend income versus comparable investment grade credits.

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.
- 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. 31	China official purchasing managers' index (PMI); U.S. Consumer Confidence
Apr. 1	Manufacturing PMI for the euro area, U.S., Japan, South Korea
Apr. 2	European Central Bank General Council meeting; U.S. factory orders
Apr. 3	U.S. nonfarm payrolls, ISM non-manufacturing PMI

Markets will keep an eye out for more signs of the impact of the pandemic disruption on growth, from manufacturing activity to consumer confidence. Last week's flash PMI data for a number of economies including the U.S. and euro area hit record lows, showing the sharp contraction in activity that we had expected. We see activity ultimately returning with limited permanent damage – with the help of an overwhelming fiscal and monetary policy response.

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.
Equities	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.
Equities	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
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. 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.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee