Weekly commentary

May 18, 2020

BlackRock

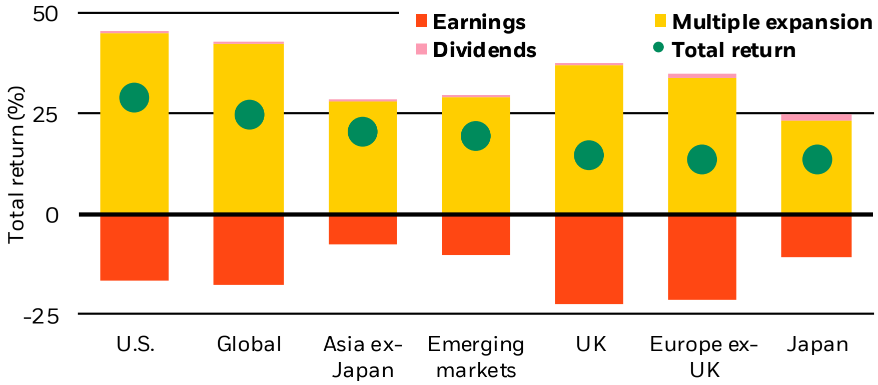
Upholding our equity views

- We favor up-in-quality equity exposures across regions and style factors even as we stay neutral on global equities overall.
- The key to the policy response has shifted to ensuring successful execution and avoiding policy fatigue before the shock passes.
- Markets will focus on the delayed annual meeting of China's top legislature, with expectations for more virus relief measures.

Global stocks have recovered more than half of the selloff triggered by the coronavirus pandemic since late March – alongside a sharp contraction in economic activity and corporate earnings. We see the unprecedented policy response to cushion the pandemic's blow as key to support global equity markets – against a backdrop of historic uncertainty for activity and earnings. We still prefer an up-in-quality stance and like economies with ample policy room as we stay neutral on global equities overall.

Chart of the week

Sources of equity total return in regional markets since March 23, 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, as of May 14, 2020. Notes: The bars show the breakdown of each market's total return into dividend, earnings growth and multiple expansion. The dots show each market's total return since March 23, 2020. Earnings growth is based on the change in the 12-month forward I/B/E/S earnings estimates since March 23, 2020. The indexes used are the MSCI index for each regional market, and the MSCI ACWI Index to represent the global market.

Global equities found their footing in late March – thanks to a swift and overwhelming fiscal and monetary policy response led by the U.S. Yet under the hood of the impressive rally lies a large dispersion in regional and style factor performance. The chart above zooms in on the sources of total return in key regional stock markets during the rally: The U.S. and Asia ex-Japan markets have outperformed broad emerging markets, the euro area and Japan – and this aligns with our overweight in the two frontrunners. An expansion of valuation multiples from cheaper levels has driven the rally across markets, even as earnings expectations contracted across the board. Lower-for-longer interest rates mechanically increase the present value of estimated future cash flows, making equities more valuable – and also relatively more attractive on cross-asset basis.

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A key feature of the equity market rally is its narrowness. The outperformance of U.S. equities so far this year is largely a function of strong gains by a handful of mega-cap technology stocks, extending a multi-year trend. The five companies with the largest market value in the S&P 500 Index account for over 20% of the index's total market capitalization. This is the highest since the tech bubble in 2000 – and potentially a warning sign. Yet these market leaders – with businesses in e-commerce and online search – are poised for better earnings as they have strong long-term growth prospects, robust financial metrics, and business models benefiting from pandemic-spurred behavioral shifts. In contrast, cyclical sectors such as energy, financials, consumer discretionary and industrials, have reported poor earnings – and challenging outlooks.

We have seen nothing short of a policy revolution in response to the pandemic – in terms of speed, size and monetary-fiscal coordination. Measures to bridge cash flows to households and businesses through the shock should limit the cumulative economic loss over time as economies reopen, even if the recovery proves slow and uneven, in our view. Effective execution of these policies is critical, as is avoiding premature policy fatigue. And poor near-term earnings prospects mean that further equity market gains are dependent on more multiple expansion. This tilts risks to the downside, keeping us neutral on global stocks over the next six to 12 months. A re-flaring of tensions between the U.S. and China is another reason for caution. We favor credit over equities over the time horizon, given central bank asset purchases and bondholders' preferential claim on corporate cash flows.

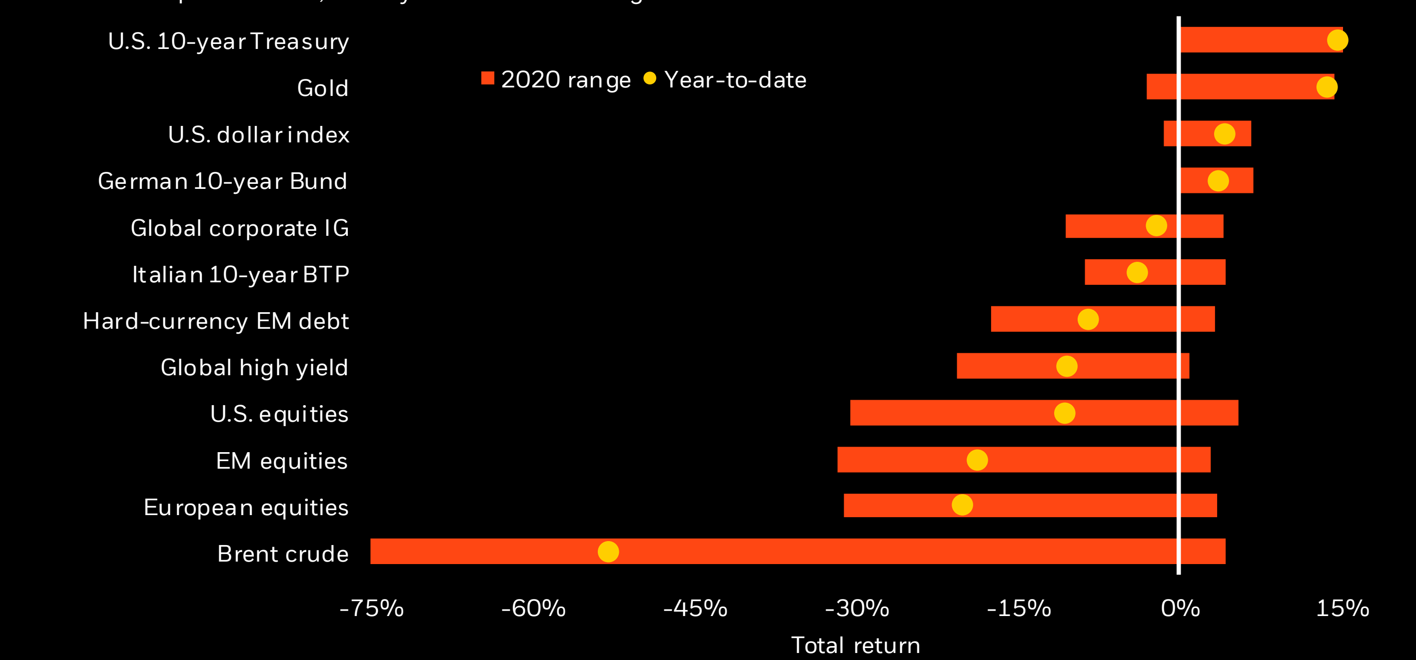
The bottom line: We still hold an up-in-quality stance in equities. This includes a preference for the U.S. market's relatively high concentration of quality companies and sectors set to ride long-term structural growth trends. We also favor Asia ex-Japan on the expectation that many countries in the region, especially China, have more policy room and have demonstrated their strength in containing the virus spread. We are underweight the euro area and Japan, as they are more dependent on foreign trade and have less willingness or capacity to engage in policy stimulus. From a factor perspective, we still favor exposure to quality and minimum volatility for their relative defensiveness during periods of slowing economic activity and heightened volatility. We stay underweight on value – a factor that typically fares poorly during periods of decelerating growth and has extended its underperformance of the past three years.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the priorities are 1) policy execution to ensure households and businesses actually receive the pledged funding; and 2) avoiding policy fatigue before the shock has passed. The U.S. administration, meanwhile, appears to be making a calculus between the perceived political benefits of being tough on China and the risk of renewed stock market volatility. Markets have so far largely looked through a string of dire economic data, with risk assets rallying from March lows.

Assets in review

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



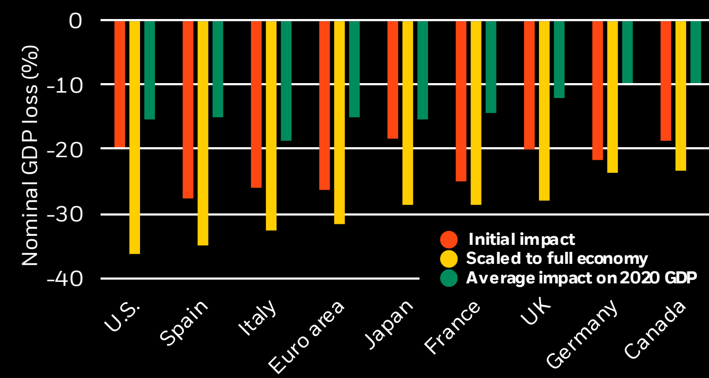
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2019, 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 initial coronavirus shock is driven by two main factors: the strictness of the lockdown measures and the reduction in mobility, as well as the role of the most affected sectors in the economy. As the initial shock ripples across the economy, the knock-on effects cause the negative impact of the lockdown to build as the initial income loss weighs on demand for goods and services. The size of this multiplier effect is larger if the share of imported goods and services is smaller, the saving rate is lower and the government's tax intake is smaller as a share of GDP. The initial shock is greater in the euro area – but the U.S. economy may suffer more overall. We can use these estimates of peak-to-trough output loss to get a first approximation of the impact on average 2020 GDP growth. It may take years for GDP to return to its pre-crisis trend. But the pace of reopening in different economies remains uncertain – and our analysis does not account for the massive policy stimulus that has been rolled out globally over the past few weeks.

Mobility matters

Potential impact adjusting for stringency and mobility



Sources: BlackRock Investment Institute, Oxford University, Apple and Google, with data from Haver Analytics, May 2020. Notes: The peak to trough loss in output depends on the severity of the lockdown and the role of the affected sectors in the wider economy. We use these estimates of output decline to get a first approximation of the impact on the average GDP growth in 2020. We use the University of Oxford's Stringency index and mobility data from Apple and Google. This analysis is subject to limitations – it does not take into account stimulus measures, and it remains uncertain how quickly different economies will reopen.

Investment themes

1 Activity standstill

- The coronavirus shock is unprecedented and sharper than what we saw in 2008 – but its cumulative hit to growth is likely to be lower as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock. The main risk to our view: The decisive policy response is not delivered in a successful and timely fashion, causing lasting damage to the economy.
- The rate of growth in virus cases looks to be slowing in many regions and stringent shutdown measures are gradually being lifted.
- The nature of the activity rebound will depend on the path of the outbreak, delivery of policy response and potential changes to consumer and corporate behaviors. Success will not just be about restarting the economy and containing the virus – but balancing both objectives.
- **Market implication**: We are mostly sticking to benchmark holdings on an asset class level and prefer credit over equities.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets is taking shape, particularly in the U.S. The U.S. unemployment rate hit its highest level since the Great Depression in April, underscoring the need for effective policy implementation.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the coronavirus shock and ensuring markets function properly. We could see its balance sheet more than double to $11 trillion by year end to support the fiscal response. The U.S. Treasury smashed records by setting out a $3 trillion borrowing plan in its quarterly refunding to fund the response – showing the blurring of lines between monetary and fiscal policy.
- A German constitutional court's ruling challenges central bank independence and threatens the integrity of the euro area in the long run. This took place just as European Central Bank data showed aggressive buying of Italian bonds to limit the widening of yield spreads, which remain near this year's peaks. It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- European Union leaders have agreed on the need for an emergency fund of at least 1 trillion euros but are still sorting out details – reinforcing the relative disappointment on policy action in the euro area.
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments (i.e by relieving bank capital and collateral requirements).
- We see risks of implementation and policy exhaustion. Next rounds of U.S. fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit.

3 Resilience rules

- Portfolio resilience has to go beyond nominal government bonds and consider alternative return sources that can provide diversification.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a tectonic shift that will carry a return advantage for years to come – and the coronavirus shock seems to be accelerating this shift.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability and Chinese assets into investment processes.

Week ahead

May 19	ZEW Indicator of Economic Sentiment	**May 21**	Flash composite purchasing managers' index (PMI) for Japan, the euro area and U.S.; Philly Fed Manufacturing Business Outlook Survey
May 20	Euro area flash consumer confidence indicator	**May 22**	China's National People's Congress annual session starts; UK retail sales

This week's slew of surveys could help gauge sentiment among businesses and consumers on the impact and duration of the virus shock. Markets will also focus on the delayed annual meeting of China's top legislature – with expectations for more relief measures to be announced – as the country is in the early days of thawing its economy from the freeze caused by the lockdown measures to combat the outbreak.

Directional views

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

Asset	Underweight	Neutral	Overweight
Equities	We are neutral on global equities. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room.		
Credit	We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.		
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

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2020

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
	Euro area	■		We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
	Emerging markets			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
	Asia ex-Japan		■	We are overweight 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 are neutral on momentum. 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 remain underweight value. 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 like 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 like U.S. Treasuries. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
	Treasury Inflation-Protected Securities			We are neutral on TIPS. 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 are reviewing our overweight in euro area peripheral government bonds. A recent German constitutional court's ruling could potentially limit the size of the European Central Bank's bond buying program.
	Global investment grade		■	We like global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
	Global high yield		■	We stay overweight high yield 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 stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some markets. Default risks may be underpriced.
	Emerging market – local currency			We are neutral on local-currency EM debt to neutral because we see a risk of further currency declines in key markets amid monetary and fiscal easing. This could wipe out the asset class's attractive coupon 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.

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