Weekly commentary

BlackRock

May 26, 2020

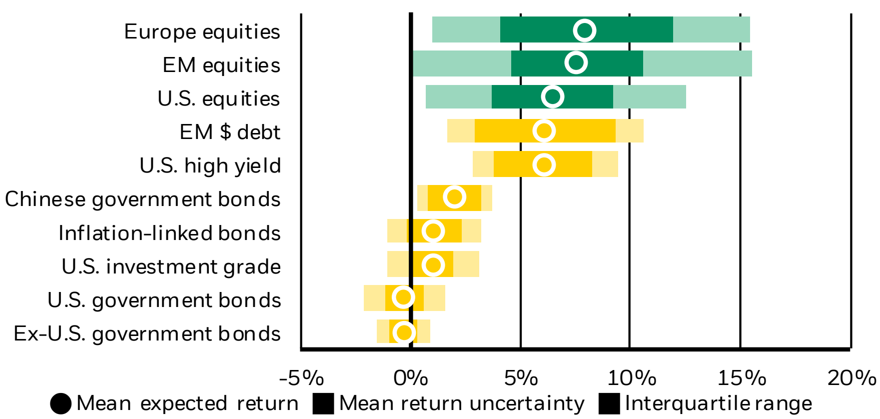
Virus compels a strategic view revamp

- The virus shock is accelerating and changing structural trends, leading us to shift our long-term return expectations and strategic views.
- The key to the policy response has shifted to ensuring successful execution and avoiding policy fatigue before the shock passes.
- This week's survey data could help gauge sentiment among businesses and consumers on the impact of duration of the virus shock.

The coronavirus shock is reinforcing structural trends and introducing new ones, such as the policy revolution, surging sustainability wave and accelerating deglobalization. In many ways, the future is arriving fast. This has led us to change our long-term return expectations - and shift our strategic asset class preferences away from nominal government bonds and toward credit.

Chart of the week

Estimated five-year annualized returns and uncertainty bands, May 2020



This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Source: BlackRock Investment Institute, May 2020. Data are as of April 13, 2020. Notes: The chart shows expected total nominal returns from a U.S. dollar perspective. Asset return expectations are gross of fees. There are two sets of bands around our mean return expectations. The darker bands show our estimates of uncertainty in our mean return estimates. The lighter bands are based on the 25th and 75th percentile of expected return outcomes – the interquartile range. The regional equity markets are represented by the MSCI regional indexes. The fixed income indexes include the JP Morgan EMBI Global Diversified Index, Bloomberg Barclays U.S. High Yield Index, Bloomberg Barclays China Treasury+Policy Bank Total Return Index, Bloomberg Barclays U.S. Government Inflation-Linked Bond Index, Bloomberg Barclays U.S. Credit Index, Bloomberg Barclays Global Aggregate Treasury Index ex U.S. and Bloomberg Barclays Government Index. Indexes are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

The latest update to our capital market assumptions, or return expectations across asset classes, reflects market price moves as well as the virus shock's potential impact on fundamentals, such as corporate earnings, default rates and medium-term inflation expectations. Our expected government bond returns have fallen across the board, and those for credit and equities have broadly risen compared to the end of 2019. Our five-year expected government bond returns are now negative across developed markets, as the chart shows. Yields have dropped sharply, and we expect only a gradual rise as we see monetary and fiscal policy coordination suppressing rates in coming years. This diminishes the strategic case for holding nominal government bonds.

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The significant price moves this year have played an important role in shifting return expectations. Potential changes in medium-term fundamentals also drive our return expectations. Take corporate earnings. The global equity market selloff earlier in the year had mechanically pushed up expected equity returns, but this repricing has been partly offset by a deteriorating earnings outlook. We see significantly reduced earnings per share this year before a gradual reversion over several years toward the prior trend of rising earnings. We also account for potentially higher corporate credit defaults and downgrades. Yet over a five-year horizon the sizeable widening in credit spreads that we've seen should compensate for increased losses due to defaults and downgrades, driving up expected returns for credit, in our view.

Another key factor is a nuanced inflation outlook. Inflation expectations have plummeted, yet we believe markets could start to price higher inflation risk once the near-term shock starts to dissipate. We see today's extraordinary policy measures as increasing inflation risks over the medium term. Central banks could be more willing to tolerate inflation overshoots despite the upward pressure on rates from high debt levels, as monetary-fiscal policy coordination has become key. Accelerated deglobalization could add to inflation risks. The overall impact is not yet clear, and the greater risk of higher inflation in the long-run is so far not reflected by market pricing. This is why we favor Treasury Inflation-Protected Securities (TIPS) as a rising allocation in strategic portfolios versus nominal DM government bonds. We also see a case for Chinese government bonds as an increased strategic allocation. They offer higher expected returns just as DM bond yields have hit record low levels, and diversification in a world of increasing U.S.-China de-coupling.

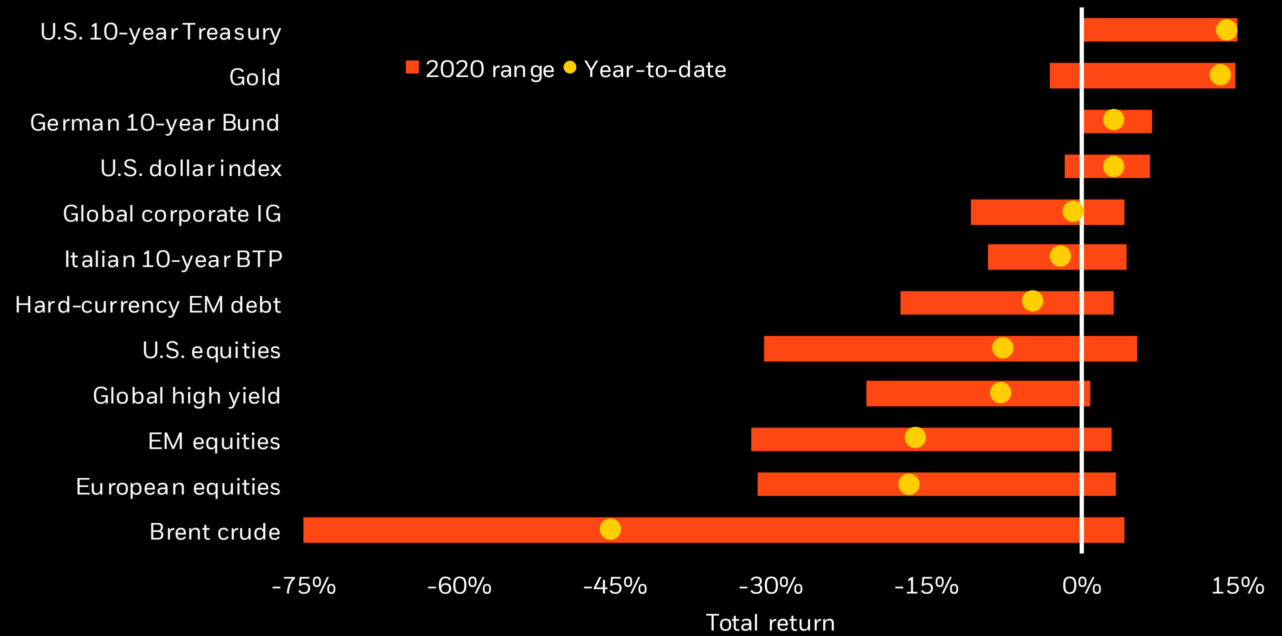
Our strategic asset views are broadly aligned with our tactical views – with two important exceptions: TIPS and regional equities. We are neutral on TIPS over the next six to 12 months due to the collapsed near-term inflation outlook despite the more favorable outlook on a strategic horizon. Over the tactical horizon we hold a modest overweight on Asia ex-Japan equities on the prospects of a growth pickup in the region, likely led by China, which is gradually lifting lockdown measures. We are also tactically overweight U.S. equities for their relative quality bias and the strong policy response to date, and underweight euro area and Japanese equities for the limited policy space to safeguard the economy against the virus shock. We prefer credit to equities on both tactical and strategic horizons, and see private markets playing a core role in portfolios.

Market backdrop

Measures to contain the virus are gradually being eased in many developed economies. May's data suggested the worst of the contraction may be behind us, but we see a bumpy restart in coming months. The big question remains: how successful policy execution will be in bridging cash flow constraints and preventing permanent damages to the economy – and what the risk is of policy fatigue in coming months. Markets became wary of rising U.S.-China tensions. A potential flashpoint is China's proposed security law for Hong Kong, which caused the biggest drop in the Hang Seng Index in five years.

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.

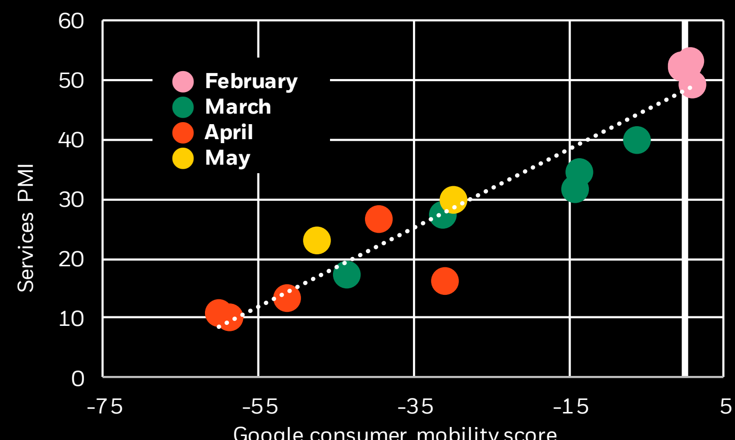
Macro insights

We should see a partial rebound in economic activity as measures to contain coronavirus are gradually eased in many economies – and people start to move around more. But normalization may be gradual. First, mobility. Lifting lockdowns does not necessarily imply a complete recovery in mobility to pre-virus levels. A partial rebound in mobility should support a bounce-back in global activity. Over the past few months, purchasing managers' index data for the U.S., Germany, France, Italy and the UK have been closely correlated with data from Google's coronavirus mobility reports. Services data reflect retail and recreational mobility (see chart), while manufacturing data correlate with mobility in work and transit locations.

Yet a recovery in mobility alone is not enough to lift the PMIs back toward the 50 level that separates contraction from expansion. Policy caution, a dent to private sector confidence and reduced global trade could all weigh on activity as economies gradually open up.

Measuring mobility

Google mobility data and services PMIs, February to May 2020



Sources: BlackRock Investment Institute and Google, with data from Haver Analytics, May 2020. Notes: The chart shows the services purchasing manager's index (PMI) for the U.S., Germany, France, Italy and the UK and the Google consumer mobility scores (data for retail and recreation activity) for those countries. The chart only shows the U.S. and the UK data for May, the latest data that is available.

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 sticking to benchmark holdings in most asset classes and prefer credit over equities.

2 Bold policy action

- A decisive, pre-emptive and coordinated policy response needed to stabilize financial markets has taken 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 joint French-German proposal for a €500 billion, European Union-wide recovery fund sparked a rally in southern-tier bonds. Failure to reach a deal so far reflects the relatively modest policy action in the euro area.
- China dropped its GDP target, emphasizing *quality* of growth over *quantity*, and announced fiscal stimulus of around 4% of GDP. This could disappoint markets that may have underestimated China's resolve to rein in leverage.
- A German constitutional court ruling threatens the European Central Bank's independence and could lead to euro area fragmentation in the long run. It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central banks have moved from alleviating dysfunctional market pricing and tightening financial conditions to ensuring credit flows to businesses and local governments.
- 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 sustainable investing.

Week ahead

May 25 German ifo Business Climate Index

May 26 U.S. Consumer Confidence and German GfK consumer sentiment (June)

May 27 The Federal Reserve Bank of Richmond monthly manufacturing activity survey

May 29 Flash estimate euro area Inflation

This week's slew of surveys could help gauge sentiment among businesses and consumers on the impact and duration of the virus shock. Markets have so far largely looked through a string of dire economic data as stringent shutdown measures are gradually being lifted, after these measures have brought economic activity to a halt earlier in the year.

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.
Equities	Euro area	■		We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
Equities	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	Minimum volatility		■	We like 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 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.
Fixed Income	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.
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 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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
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.

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