# Weekly commentary

BlackRock

August 10, 2020

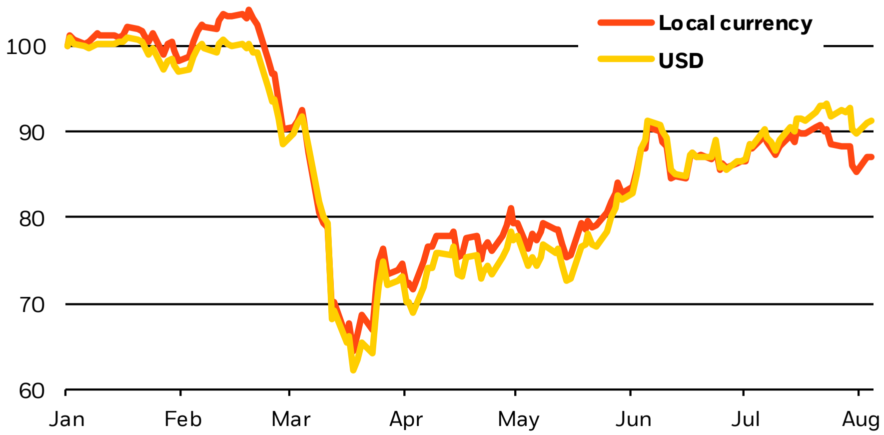
## Implications of a weaker dollar

- Europe's more favorable virus and policy dynamics versus the U.S. have helped pressure the U.S. dollar, underscoring our preference for European equities.
- Negotiations over a new U.S. fiscal package to cushion the virus shock dragged on as key benefits expire and states face budget shortfalls.
- U.S. and German data this week will shed light on consumer sentiment amid ongoing concerns about renewed spread of the coronavirus around the world.

A prolonged period of U.S. dollar gains has reversed abruptly. The policy revolution to cushion the pandemic's blow is a key driver, as it has eroded the dollar's interest rate advantage and helped lift risk appetite off its March trough, in our view. The different restart dynamics in the U.S. and Europe have also pressured the dollar, underscoring our preference for European equities and caution on U.S. stocks.

### Chart of the week

Euro area equity return in local currency vs. in U.S. dollar, 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, as of August 5, 2020. Notes: The chart compares the price returns of the MSCI EMU Index in local currency terms and in U.S. dollar terms. The returns are rebased to 100 at the start of 2020.

We upgraded European stocks to overweight, on the back of the region's robust public health infrastructure and a galvanized policy response. These two factors have moved the currency market more than the equity market so far. Unhedged, dollar-based investors in European equities have benefitted as a result, even as returns in euro terms have lagged. The price return in dollar terms (yellow) had largely trailed that in local-currency terms (orange) until late June when the trend reversed. See the chart above. We see the fundamental dynamics ultimately flowing through and helping local-currency equity returns. We are much less sanguine about emerging market (EM) equities as many EM countries outside northern Asia struggle to contain the virus spread and have limited policy space to cushion the virus shock, even with the help of a weaker dollar.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The dollar had enjoyed a decade of nearly uninterrupted gains – and had a strong start in 2020 in part helped by pandemic-triggered global risk aversion and a seizing-up of the dollar funding market. We see the unprecedented policy revolution as helping reverse that trend since March. The Federal Reserve and other central banks have cut rates and initiated other easing measures, leading to the compression of interest rate differentials between the U.S. and most developed economies, just as governments have unleashed fiscal stimulus to help households and businesses bridge the virus shock. The forceful policy response has revived risk appetite, driving investors away from perceived safe-haven assets. The Fed's measures to alleviate the dollar funding shortage also helped take the wind out of the greenback's rally.

The euro as well as a handful of other European currencies have led the outperformance against the dollar in recent months, cheered on by the region's improving virus dynamics and galvanizing policy response. The creation of the European recovery fund, and its upcoming issuance of pan-European bonds, has been a boon for the euro. The situation in the U.S. appears less encouraging. Negotiations over the next round of fiscal relief measures have dragged on even as key benefits expire, while COVID cases are rising in most of the country. We expect dollar weakness to persist in the near term as the drivers for its recent decline remain in place. The longer-term outlook is harder to gauge. A key question is the currency implications of the policy revolution – especially if and how central bankers build guardrails to manage growing balance sheets in the face of greater fiscal deficits and debt issuance. The prospect of the dollar retaining its perceived safe-haven status is another concern. We are weighing these as a contentious U.S. presidential election looms.

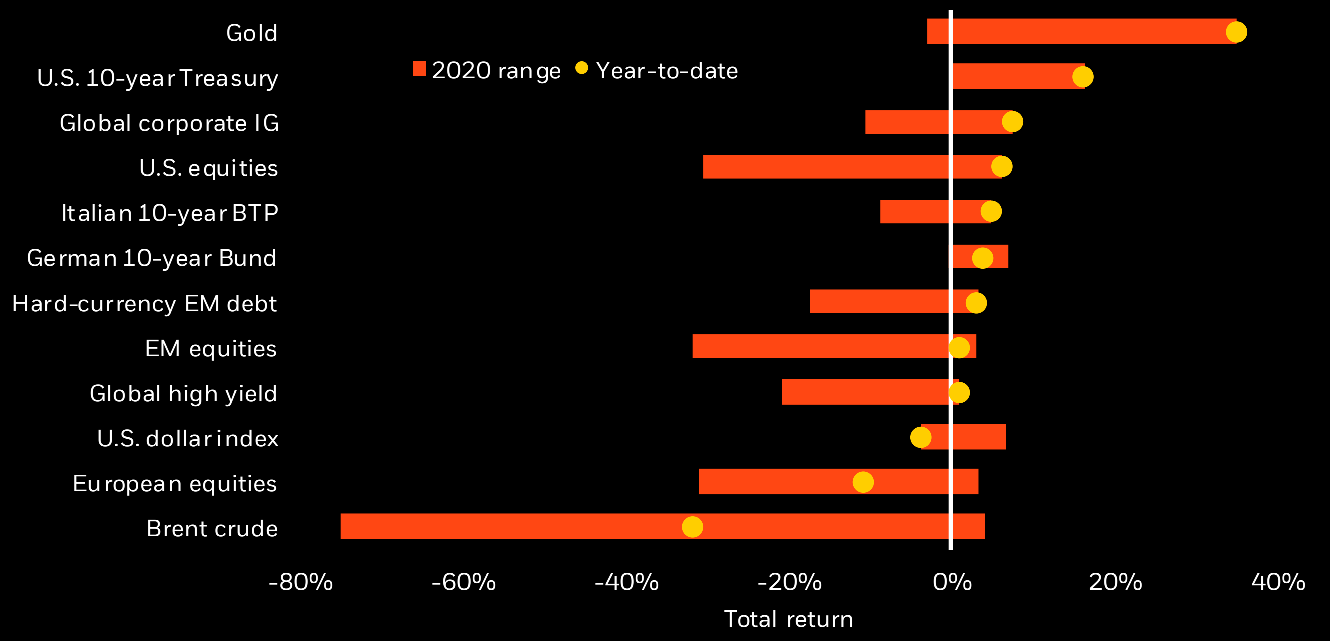
The bottom line: The shifting pandemic and restart dynamics in the U.S. and Europe have helped weaken the dollar and strengthen the euro, underpinning our overweight on European stocks and caution on their U.S. peers. A weaker dollar generally is positive for EM assets, yet we see the relatively weak public health infrastructure and limited policy space more than offsetting such benefit across much of the EM complex. We are underweight EM equities overall and EM dollar debt, as many of developing countries have limited capacity to control the virus spread and cushion the blow to the economy. We are neutral and more constructive on EM Asia equities and local-currency EM debt.

# Market backdrop

Activity has started to normalize in both Europe and North Asia, albeit with localized lockdowns to contain virus clusters. The pandemic is still spreading in the U.S. and many emerging markets. The unprecedented policy response has boosted risk assets. Europe has agreed on a historic recovery fund, but U.S. stimulus is now at risk of fading. Talks over the size and makeup of a new U.S. fiscal package have dragged on as some key benefits expired and states face huge budget shortfalls. We could see a $1-1.5 trillion fiscal package that extends some (but not all) federal stimulus measures through late-2020.

## 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, August 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.

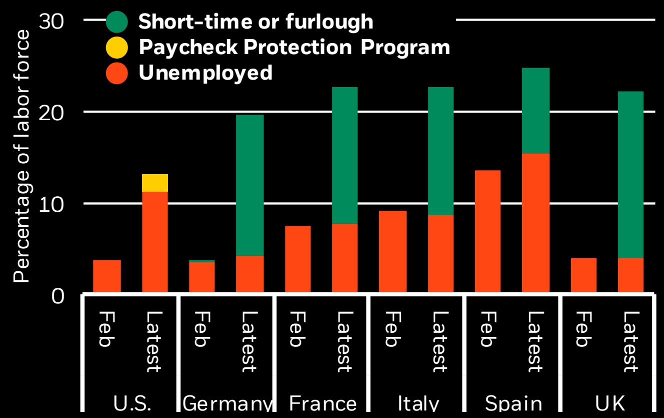
# Macro insights

The cumulative GDP loss as a result of the COVID-19 shock should be much smaller than that caused by the global financial crisis, in our view. But the recovery is likely to be slow and policy support remains key. U.S. personal disposable income grew at a record 44.9% annual rate in the second quarter thanks to fiscal transfers. Without those, it actually fell by a record 22.3%.

The number of workers who are either unemployed or on a short-time work programs remains far above pre-pandemic rates, as the *Labor support* chart shows. The increase in U.S. unemployment has outstripped that in Europe. Most of it is classified as temporary, helping to limit the long-term damage as activity restarts. Yet the unemployed have faced uncertainty over future unemployment benefits, and this could take a toll on consumer sentiment. In Europe, short-time work programs are giving workers more protection in the short run by keeping them attached to their jobs – at a typical replacement rate of 70-80% of wages. There is no imminent cliff edge.

## Labor support

Workers unemployed or on support programs, 2020




Sources: BlackRock Investment Institute, U.S. BLS, the UK ONS, Eurostat, the French Statistical Office for Labour and Employment, the Spanish labor ministry, the Italian labor ministry and Autor et al (2020), with data from Haver Analytics. Notes: Latest estimates relate to June 2020, except for the UK for which only May data available. Official estimates of workers covered by the U.S. PPP scheme are not available, so the yellow bar uses an estimate published by Autor et al.

# Investment themes

## 1 Activity restart

- Economies are slowly restarting, but at different paces. We are tracking the evolution of the virus and mobility. The longer it takes for activity to restart, the more cracks might appear in the financial system and productive capacity.
- Activity has restarted in North Asia and Europe, albeit with localized lockdowns to contain virus clusters. Surging infections in U.S. Sunbelt states have reversed reopening measures and started to affect activity there.
- 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 moderately pro-risk, and express it in an overweight to credit in strategic, long-term portfolios. We prefer Europe among cyclical equity exposures on a tactical horizon.

## 2 Policy revolution

- The policy revolution was needed to cushion the devastating and deflationary impact of the virus shock. In the medium term, however, the blurring of monetary and fiscal policy could bring about upside inflation risks. It's crucial to have proper guard rails around policy coordination, as we discuss in Policy Revolution.
- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the shock and ensuring markets function properly, but has so far steered clear of committing to explicit yield curve control.
- After a slow start, Europe has followed suit. The European Central Bank started fresh and more flexible quantitative easing. European leaders agreed on a historic €750 billion European recovery plan that introduces mutualized debt and creates jointly issued European bonds that can compete with other perceived safe-haven assets.
- EU leaders appear committed to the recovery plan, but it may take time to implement.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows.
- We see a risk of policy exhaustion, especially in the U.S. Enhanced jobless benefits expired on July 31, and negotiations on new fiscal relief measures have dragged on. We could see a $1-1.5 trillion fiscal package that extends some federal stimulus measures through late-2020. Aid to states and local governments is a key item, with many facing budget holes.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically, we overweight credit and European equities, and see U.S. stocks at risk of fading fiscal stimulus.

## 3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. Countries and sectors will make a comeback as diversifiers in a more fragmented world, in our view, offering resilience to real economy trends.
- Portfolio resilience has to go beyond broad asset class diversification alone. Investors should consider alternative return sources that can provide diversification, such as private markets.
- 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 sustainable assets, private markets and deliberate country diversification for strategic portfolios. We have increased our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

## Week ahead

| | |
|---|---|
| **Aug 10–17** | China inflation, total social financing, money supply and new loans |
| **Aug 11** | German ZEW Indicator of Economic Sentiment |
| **Aug 12** | UK second-quarter gross domestic product; U.S. consumer price index |
| **Aug 14** | University of Michigan Surveys of Consumers; China industrial output |

Markets will focus on the sentiment data from Germany and the U.S., after some levelling-off of some sentiment indicators amid ongoing concerns of renewed spread of the virus around the world. A flurry of data from China, including inflation, industrial output, retail sales and lending, could shed light on the progress of the activity restart in the world's second-largest economy.

## Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, Aug 2020

| Asset | Strategic view | Tactical view | |
|---|---|---|---|
| **Equities** | Neutral | Neutral | We have turned neutral on equities on a strategic horizon given the challenging backdrop for earnings and dividend payouts. We trim our modest overweight in EM and maintain our DM exposure at neutral. Tactically, we are also neutral on equities. We like the quality factor for its resilience and favor Europe among cyclical exposures. |
| **Credit** | +1 | +1 | We have moved to a strategic overweight on credit after being underweight for the past year. Sizeable spread widening compensates for the risks of defaults and downgrades, in our view. On a tactical horizon, extraordinary measures by central banks – including purchases of corporate debt – are supportive. Risks of a temporary liquidity crunch remain, but coupon income is crucial in a world starved for yield. |
| **Govt bonds** | -1 | Neutral | The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. The "even-lower-for-even-longer" outlook for rates is compromising the asset class' ability to act as ballast against equity market selloffs in the long run. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation skews yields to the downside. |
| **Cash** | | Neutral | We are neutral on cash and are using it to support our view on credit. Some cash makes sense as a buffer against supply shocks that drive both stocks and bonds lower. |
| **Private markets** | Neutral | | Non-traditional return streams, including private credit, have the potential to add value and diversification. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private assets reflect a diverse array of exposures–but valuations and greater inherent uncertainties of some private assets keep us neutral overall. |

Note: Views are from a U.S. dollar perspective, August 2020. 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

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

| | Asset | Underweight | Overweight | |
|---|---|---|---|---|
| Equities | United States | | | We downgrade U.S. equities to neutral. Risks of fading fiscal stimulus and an extended epidemic are threatening to derail the market's strong run. Renewed U.S.-China tensions and a divisive election also weigh. |
| | Euro area | | | We upgrade European equities to overweight. The region is exposed to a cyclical upside as the economy restarts, against a backdrop of solid public health measures and a galvanizing policy response. |
| | Japan | | | We upgrade Japanese equities to neutral. We see strong fiscal policy and public health measures allowing for rapid normalization. |
| | Emerging markets | | | We downgrade emerging market equities to underweight. We are concerned about the pandemic's spread and see less room or willingness for policy measures to cushion the impact in many – but not all – countries. |
| | Asia ex-Japan | | | We downgrade Asia ex-Japan equities to neutral. Renewed U.S.-China tension is a risk. China's goal to balance growth with financial stability has led to relatively muted policy measures to cushion the virus fallout. |
| | Momentum | | | We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold. |
| | Value | | | We upgrade value to neutral. We see the ongoing restart of economies likely benefiting cyclical assets and potentially helping value stage a rebound after a long stretch of underperformance. |
| | Minimum volatility | | | We downgrade min vol to neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures. |
| | Quality | | | We increase our overweight in quality. We see it as the most resilient exposure against a range of outcomes in terms of developments in the pandemic and economy. |
| Fixed Income | U.S. Treasuries | | | We like U.S. Treasuries. Long-term yields are likely to fall further than other developed market peers, even as low rates reduce their ability to cushion against risk asset selloffs. |
| | Treasury Inflation-Protected Securities | | | We are neutral on TIPS. A huge decline in rates 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 as current yield levels provide little cushion against major risk events. Also, potential issuance related to the proposed EU recovery fund could compete with bunds for investment. |
| | Euro area peripherals | | | We overweight euro area peripheral government bonds despite recent outperformance. We see further rate compression due to stepped-up quantitative easing by the European Central Bank and other policy actions. |
| | Global investment grade | | | We overweight global investment grade credit even as valuations have risen. Asset purchases by central banks and a broadly stable rates backdrop support the sector. |
| | Global high yield | | | We stay overweight high yield as a source of income despite recent underperformance. We avoid energy as lower oil prices challenge the ability of issuers to refinance near-term maturities. |
| | Emerging market – hard currency | | | We have downgraded hard-currency EM debt due to the pandemic's spread, heavy exposure to energy exporters and limited policy space in some emerging economies. Default risks may be underpriced. |
| | Emerging market – local currency | | | We remain neutral on local-currency EM debt for its attractive coupon income. Currencies have adjusted and valuations have cheapened. A risk of further currency declines remains amid monetary and fiscal easing. |
| | Asia fixed income | | | We have turned neutral on Asia fixed income. The pandemic's containment in many countries and low energy exposure are positives. Renewed U.S.-China tensions and China's relatively muted policy fallout are risks. |

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