Weekly commentary

BlackRock

May 10, 2021

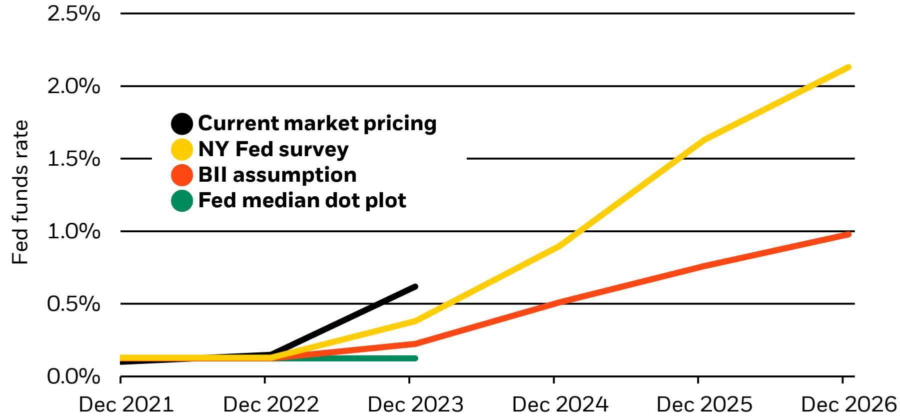
Mind the (rate expectation) gap

- Markets are still grappling with the Federal Reserve's new framework, leading to a disconnect between market pricing and the Fed's projections for rates.
- U.S. job growth unexpectedly slowed in April. We believe near-term activity data will unlikely affect the Fed's policy rate outlook and shouldn't be extrapolated.
- We expect broadly stable growth in China's total social financing – the broadest liquidity measure. U.S. retail data should shed light on the status of the restart.

Markets are pricing in a liftoff from near-zero policy rates as early as next year, even though the Fed through its new framework has committed to stay behind the curve on inflation. We caution against extrapolating too much from strong near-term activity data amid a powerful restart. We see a high bar for the Fed to change its policy stance and believe this may be underappreciated by markets.

Chart of the week

Expectations for U.S. policy interest rates, 2021-2026



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, Federal Reserve and Federal Reserve Bank of New York, with data from Refinitiv Datastream, May 2021. Notes: The chart shows expectations for the federal funds rate, the Fed's policy target. Market pricing is based on futures on the U.S. dollar Secured Overnight Financing Rate. We use the median forecast in the March 2021 Survey of Market Participants by the New York Fed. The BII assumption is part of our economic projections in our capital market assumptions. The Fed median dot plot comes from the January 2021 Summary of Economic Projections.

The Fed has reiterated its intention to stay behind the curve on inflation under its new framework that implies inflation overshoots to make up for past misses. Yet this has been met with some skepticism in markets, against the backdrop of a powerful economic restart. Current market pricing and consensus expectations suggest the federal funds rate, the Fed's policy rate, would start rising much sooner than Fed officials' own projections would indicate. See the chart above. We see two reasons for this disconnect. First, investors may be over-extrapolating from near-term growth data amid the powerful economic restart. We view the Covid shock as more akin to a natural disaster followed by a rapid "restart" – instead of a traditional business cycle recession followed by a "recovery." That implies the huge near-term growth spurt will be transitory. And second, we believe many are still wedded to the central bank's old policy framework, and may underestimate the central bank's commitment to push inflation above target.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist -BlackRock Investment Institute

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

BlackRock **Investment** Institute

Market chatter about a potential tapering of the Fed's asset purchases has gotten louder, yet we don't see the Fed discussing this imminently. Tapering is the first step towards normalization of Fed policy, but even a discussion later this year does not mean the liftoff is close. There is a risk the discussion could trigger market volatility or be miscommunicated by the Fed. We believe investors should look through any such bouts of volatility, as our *new nominal* theme implies that the Fed will likely be much slower than in the past to raise rates in the face of rising inflation.

Inflation – not the near-term growth outlook – is key to the Fed's rate outlook under the new framework, in our view. We believe two important developments would need to take place before the Fed considers a liftoff. First, the realized core personal consumption expenditures (PCE) price index, the Fed's preferred inflation gauge, should stay at or around the Fed's 2% target for a sustained period of time. The current inflation overshoot doesn't meet the bar as the Fed views it as driven by transient factors. We also see uncertainties around the near-term persistence of the overshoot as the restart has led to unusual supply and demand dynamics. This is why we have recently closed our overweight in inflation-linked bonds over the tactical horizon. Second, the Fed's inflation *forecast* would need to rise from current levels and point to a prolonged period of moderately above-target inflation. What could potentially pull forward the Fed's timetable for a liftoff? An upward spiral in prices and wages set in motion by behavior of individuals and firms could be one driver, in our view.

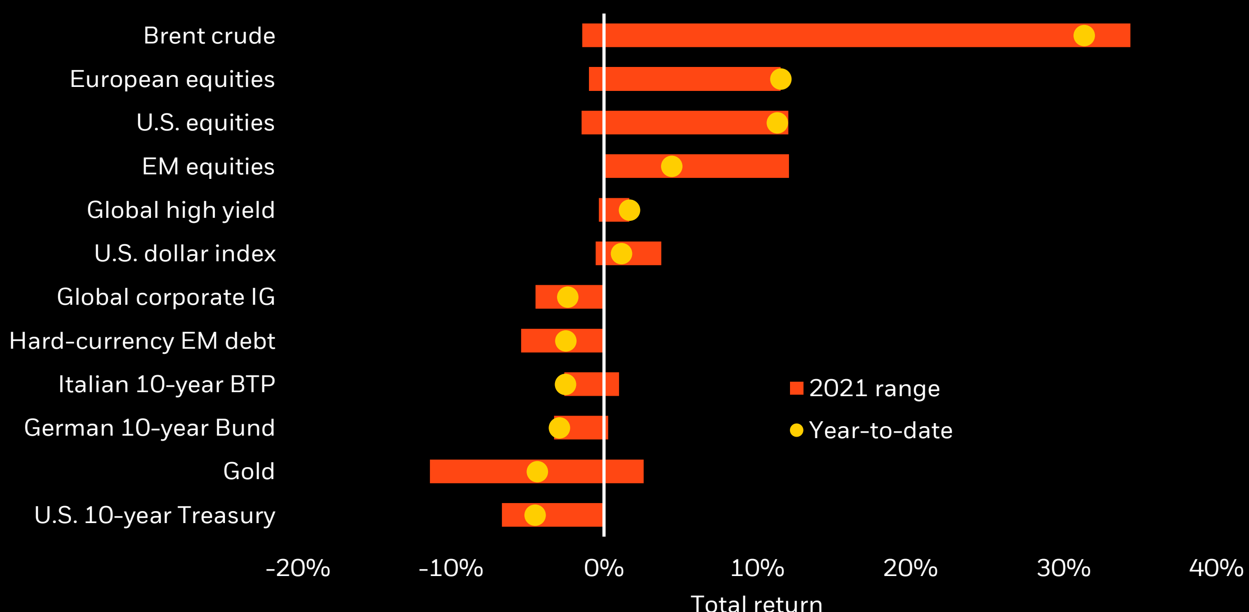
The bottom line: The Fed is in the process of building credibility in the framework and has set a high bar to change its easy policy stance, even in the face of higher realized inflation. This implies that eye-popping growth numbers in coming months will be largely irrelevant to its rate outlook – and the restart momentum shouldn't be over-extrapolated, in our view. The implication: stay invested as the restart broadens out. We are still pro-risk, but the support for this stance has shifted from our expectation for the restart to surprise to the upside to our belief markets are underappreciating the Fed's commitment to its new framework. Risks to this view include market overreaction to the near-term growth rebound and worsening virus dynamics. We believe the near-term spike in inflation is barely making a dent in the cumulative inflation shortfalls after many years of misses, and expect medium-term inflation to gradually rise. Over the strategic horizon, we are underweight nominal government bonds and prefer inflation-linked bonds.

Market backdrop

U.S. nonfarm payrolls growth was much slower than expected in April. We believe the market is too aggressive in its pricing of a policy rate lift-off in the U.S. and don't think near-term growth or employment data will likely affect the Fed's rate policy outlook. U.S. stocks hit record highs. Among nearly 90% of S&P 500 companies that have reported first-quarter earnings, 87% have beaten estimates, Refinitiv data showed.

Assets in review

Selected asset performance, 2021 year-to-date and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of May 6, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, and the dots represent current 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, in descending order: spot Brent crude, MSCI Europe Index, MSCI USA Index, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global Broad Corporate Index, J.P. Morgan EMBI index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream, spot gold and U.S. 10-year benchmark government bond index.

Macro insights

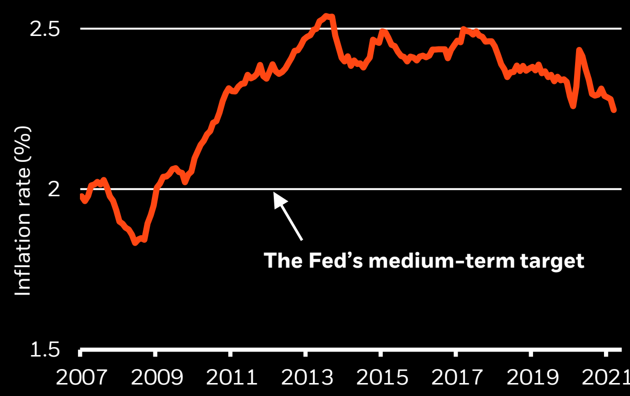
The Fed's new policy framework is designed to counter stubbornly low inflation by flexibly targeting an average core PCE inflation rate of 2% over the long-run. Persistent misses over the past decade suggest the Fed will aim at inflation overshooting their target in coming years – and adopt a much more patient approach to policy normalization, in our view.

The chart shows where annual inflation would need to be, on average, over the subsequent five years to hit the Fed's target. This makeup rate – currently just under 2.3% – is consistent with inflation being 'moderately above 2%,' which the Fed has said it is aiming to achieve. But it is persistently higher than the Fed's own forecast of inflation from March 2021. Inflation has run below target in the U.S. for most of the post-global financial crisis period, suggesting substantial periods of inflation overshoots will be needed to close the gap.

The near-term spike in inflation will not made much of a dent in the cumulative inflation shortfall, in our view, suggesting monetary policy is likely to remain highly accommodative for some time. See our macro insights hub for more.

Playing catch-up

Estimated inflation makeup rate vs. Fed target



Sources: BlackRock Investment Institute and Federal Reserve, with data from Refinitiv Datastream and Haver Analytics, May 2021. Notes: The inflation makeup rate shows our estimate of how much annual inflation would need to be, on average, over the subsequent five years, to hit the Fed's target of an average inflation rate of 2% (dotted line) over the medium term under its current policy framework.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart, powered by pent-up demand and sky-high excess savings. The huge growth spurt will be transitory, in our view. This is because a restart is not a recovery: the more activity restarts now, the less there will be to restart later.
- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – was confirmed by the Fed's March policy meeting. The Fed made it clear that the bar for reassessing its policy rate path was not met and that it was too soon to talk about tapering bond purchases. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **Market implication**: We favor inflation-linked bonds amid inflationary pressures in the medium term. Tactically we prefer to take risk in equities over credit amid low rates and tight spreads.

2 Globalization rewired

- Covid-19 has accelerated geopolitical transformations such as a bipolar U.S.-China world order and a rewiring of global supply chains, placing greater weight on resilience.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels and U.S.-China conflicts, but we believe investors are compensated for these risks.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like Asia ex-Japan equities, and see UK equities as an inexpensive, cyclical exposure.

3 Turbocharged transformations

- The pandemic has added fuel to pre-existing structural trends such as an increased focus on sustainability, rising inequality within and across nations, and the dominance of e-commerce at the expense of traditional retail.
- The pandemic has focused attention on underappreciated sustainability-related factors and supply chain resilience.
- It has also accelerated "winner takes all" dynamics that have led to the strong performance of a handful of tech giants in recent years. We see tech as having long-term structural tailwinds despite its increased valuations, yet it could face challenges from higher corporate taxes and tighter regulation under a united Democratic government.
- The pandemic has heightened the focus on inequalities within and across countries due to the varying quality of public health infrastructure – particularly across EMs – and access to healthcare.
- **Market implication**: Strategically we see returns being driven by climate change impacts, and view developed market equities as an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

May 9-16	China total social financing and new yuan loans
May 14	U.S. retail sales, University of Michigan Surveys of Consumers
May 11	German ZEW economic sentiment

China's lending data will be in focus this week. We expect China's total social financing data – the broadest measure of liquidity supply to the real economy – to be broadly stable. in line with goals of policymakers. U.S. retail sales data – as well as the University of Michigan sentiment survey – should shed light on the restart of consumer sector as more states are lifting virus restrictions.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We are overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indexes. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a bias for quality.
Credit	-1	Neutral	We are underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, credit, especially investment grade, has come under pressure from tightening spreads, but we still like high yield for income.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and rising debt levels may eventually pose risks to the low-rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. We are underweight duration on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart.
Cash		Neutral	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.
Private markets	Neutral		We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, May 2021. 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

Change in view

Previous → New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2021

	Asset	Underweight	Overweight	
Equities	United States			We are overweight U.S. equities. We see the tech and healthcare sectors offering exposure to structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
	Euro area			We are neutral European equities. We believe the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
	Emerging markets			We are overweight EM equities. We see them as principal beneficiaries of a vaccine-led global economic upswing in 2021. Other positives: our expectation of a flat to weaker U.S. dollar and more stable trade policy under a Biden administration.
	Asia ex-Japan			We are overweight Asia ex-Japan equities. Many Asian countries have effectively contained the virus – and are further ahead in the economic restart. We see the region's tech orientation allowing it to benefit from structural growth trends.
	UK			We are overweight UK equities. The removal of uncertainty over a Brexit deal should see the risk premium on UK assets attached to that outcome erode. We also see UK large-caps as a relatively attractive play on the global cyclical recovery as it has lagged peers.
	Momentum			We keep momentum at neutral. The factor has become more exposed to cyclicality, could face challenges in the near term as a resurgence in Covid-19 cases and a slow start to the vaccination efforts create potential for choppy markets.
	Value			We are neutral on value despite recent underperformance. The factor could benefit from an accelerated restart, but we believe that many of the cheapest companies – across a range of sectors – face structural challenges.
	Minimum volatility			We turn neutral min vol. Our regional and sectoral preferences warrant a higher exposure to the factor. Min vol's underperformance has brought valuations to more reasonable levels in our view.
	Quality			We are overweight quality. We like tech companies with structural tailwinds and see companies with strong balance sheets and cash flows as resilient against a range of outcomes in the pandemic and economy.
	Size			We are overweight the U.S. size factor. We see small- and mid-cap U.S. companies as a key place where exposure to cyclicality may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. The accelerated economic restart has sent yields surging, but we prefer to stay underweight as we expect short-term rates will stay anchored near zero.
	Treasury Inflation-Protected Securities			We are neutral TIPS after the sharp rise in inflation expectations since late year. Further increases seem unlikely in the near-term. We still see inflation pressures building over the medium term due to structural reasons.
	German bunds			We are neutral on bunds. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
	Euro area peripherals			We are neutral euro peripheral bond markets. Yields have rallied to near record lows and spreads have narrowed. The ECB supports the market but it is not price-agnostic - its purchases have eased as spreads have narrowed.
	Global investment grade			We are underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
	Global high yield			We are moderately overweight global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			We are overweight EM local debt as its year-to-date underperformance has left valuations more appealing, particularly if U.S. Treasury yields and the U.S. dollar stabilize. We see limited contagion to broader EM from selected country-specific volatility.
	Asia fixed income			We are overweight Asia fixed income. We see the asset class as attractively valued. Asian countries have done better in containing the virus and are further ahead in the economic restart.

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.

Not FDIC Insured • May Lose Value • No Bank Guarantee