Weekly commentary

BlackRock

July 19, 2021

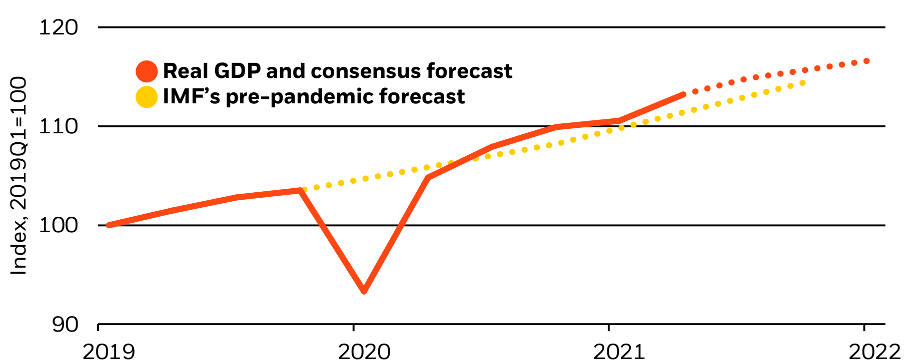
Our views on China's policy finetuning

- We view China's monetary policy loosening as unlikely to derail a focus on quality growth in the medium term, supporting our views on Chinese assets.
- U.S. consumer price index (CPI) rose more than expected in June amid the restart dynamics. China's economy grew slightly slower than expected in Q2.
- We expect the European Central Bank (ECB) to update its forward guidance on monetary policy decisions at its first policy meeting after the strategic review.

We see China's recent policy loosening as an important shift to a modestly more supportive stance for the near term, yet don't expect the overall hawkish bias to change as it is crucial in China's focus on quality growth in the medium term. This is supportive of our views on China: We are neutral on equities and overweight government bonds tactically, and positive on both on a strategic horizon.

China's slowing growth

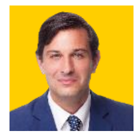
Actual and estimated China real GDP, 2019-2022



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, International Monetary Foundation, Thomson Reuters, with data from Refinitiv, July 2021. Notes: The solid orange line shows the actual path of Chinese real gross domestic product (GDP) from 2019 onwards. The yellow dotted line shows the IMF's projections outlined in its 2019 October World Economic Outlook – the last published estimate before the Covid shock hit. The data is rebased to 100 at the first quarter of 2019.

We debuted our standalone China asset views in our Midyear 2021 global outlook, as we believe it is time to treat it as an investment destination separate from emerging markets (EM) and developed markets (DM). China's policymakers have held a hawkish stance since mid-2020; China's economy returned to its pre-pandemic growth trend in late 2020, as shown in the chart. In recent months growth has shown signs of slowing, though last week's data was largely positive, with better-than-expected June activity data and slower-than-expected second-quarter GDP growth. This may have given Beijing the incentive to frontload policy support in order to stave off a potentially more pronounced slowdown, especially as inflation pressures have eased, in our view. Earlier this month the People's Bank of China cut the reserve requirement ratio for most banks, or the required amount of cash banks must hold as reserves. We see potential for more, broad-based loosening in the near term, including in fiscal and other policies. Yet we expect a measured approach from policymakers, and see their medium-term hawkish stance unchanged despite the near-term finetuning. A Chinese Communist Party's politburo meeting later this month will be key to watch.

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute



Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

Yu Song
Chief China Economist – BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

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We see an overall hawkish policy stance as critical to China's "quality revolution" – an effort to move away from an overriding effort on the quantity of growth toward a greater focus on the quality of growth. China aims to become a more productive economy with each unit of incremental GDP generating proportionately less pollution, inequality and financial risk (debt). This is key to our China asset views. We are tactically neutral on Chinese equities but strategically positive because we believe ongoing reforms in China could weigh on near-term growth but potentially improve its quality in the long run. We are overweight Chinese government bonds on both tactical and strategic basis as we believe China will continue to have relatively high nominal and real yields compared to global peers, thanks to its hawkish policy stance. The persistent inflows to China bond exchange-traded products (ETPs) have underlined the appeal. Year-to-date cumulative flows into global China bond ETPs stood at $14.1 billion as of July 12, vs. a record $16.2 billion in 2020, our data showed.

Monetary and fiscal policy tightening is just one aspect of China's overall hawkish policy stance, with the other two being measures to stabilize property price increases and an anti-monopoly clampdown. Property market policies will unlikely change much, in our view. The anti-monopoly campaign has become a significant market driver, causing China's tech sector to shed as much as $1 trillion in market capitalization since February. As a result, market positioning has become much less crowded in this space and market pricing now looks to be somewhat reflecting the clampdown. We expect this campaign to continue, but see potential for reduced intensity as the government's near-term focus shifts to encouraging growth. This renewed focus on growth may also continue to keep credit defaults contained, after the effort to restructure China's credit markets to nurture more productive companies and a healthier economy has driven an increase in corporate debt defaults this year, in our view.

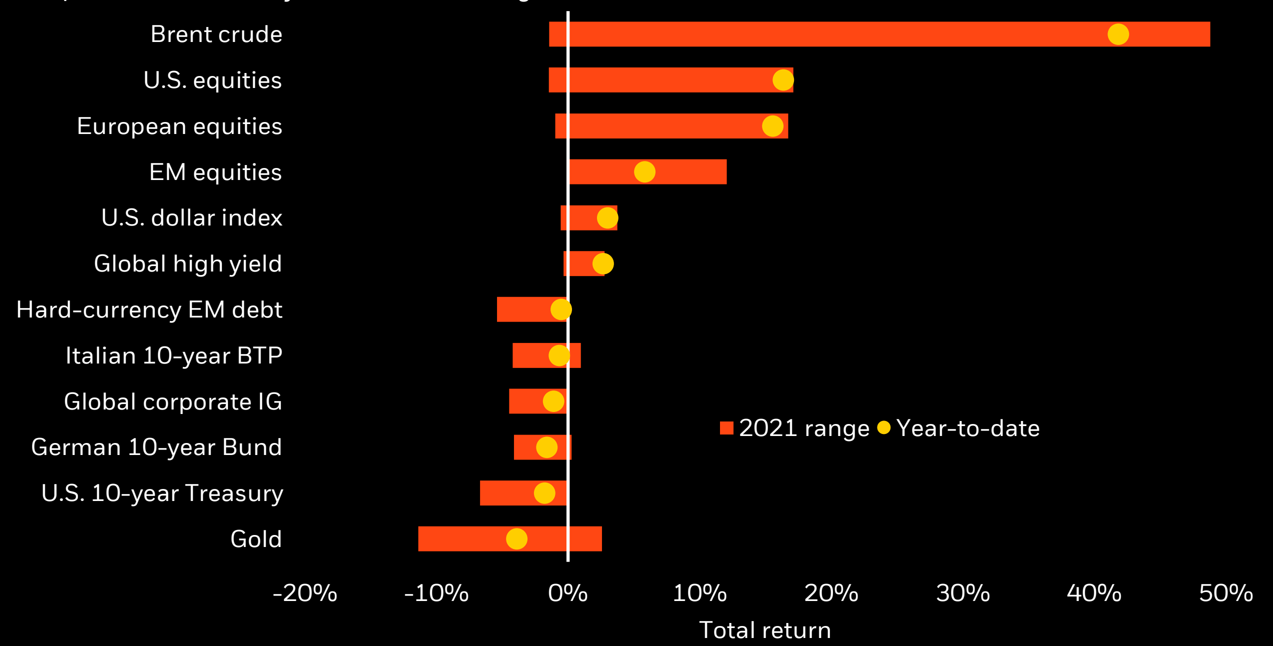
The bottom line: China's policymakers may be loosening up policy for the near term, but we still expect them to uphold the hawkish stance over the medium term to advance its quality revolution. Strategically we see a need for dedicated exposures to China as one of the two poles of global. We recognize implementation of our asset views will differ across investor types and geographies, depending on objectives, constraints and regulation.

Market backdrop

U.S. consumer price index (CPI) gained 0.9% in June, the largest rise in 13 years, driven by the unusual supply and demand dynamics amid the powerful economic restart. We expect a higher inflation regime in the medium term – as a result of a more muted monetary policy response than in the past. In a noisy and unprecedented economic restart, volatility in data and market reaction is to some extent expected, in our view. China's GDP increased 7.9% year on year in the second quarter, slightly slower than expectations.

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 July 15, 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 USA Index, MSCI Europe Index, MSCI Emerging Markets Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream U.S. 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and spot gold.

Macro insights

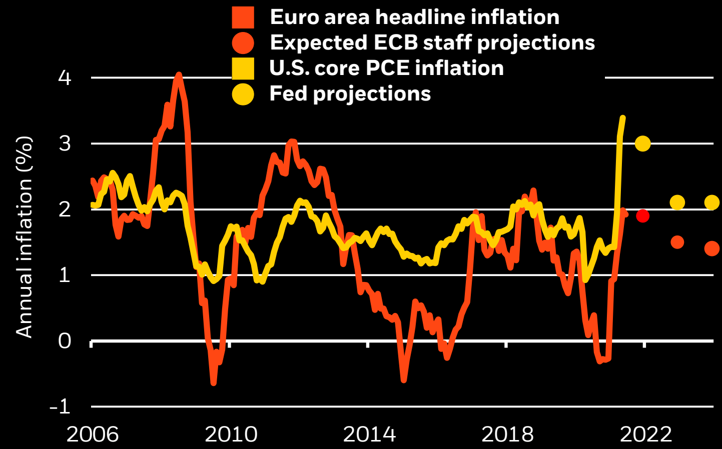
Inflation is rising with the economic restart underway. Looking beyond the restart dynamics, we believe central bank policies will likely be the principal driver of inflation. Here we see a stark contrast between the inflation outlook for the U.S. and that for the euro area.

The Federal Reserve actively seeks an overshoot in inflation to make up for past misses under its new policy framework. It projects inflation above 2% well into 2023. See the chart. In contrast, the ECB will merely tolerate a moderate overshoot of 2% inflation. We see getting above the 2% inflation target as difficult and ECB staff projections see inflation falling to well below target over the medium term. We expect the ECB to remain relatively dovish as a result, particularly given its persistent misses in the past.

The relatively stronger inflation outlook in the U.S. compared to the euro area – in both the short and longer term – underpins our overweight in Treasury Inflation-Protected Securities (TIPS) relative to European breakevens. See our macro insights hub.

Contrasting inflation outlooks

Euro area and U.S. inflation and central bank forecasts, 2006-2023



Sources: BlackRock Investment Institute, Bureau of Economic Analysis, Eurostat, Federal Reserve, ECB. Notes: The Federal Reserve projections show Q4 annual inflation published in the FOMC Summary of Economic Projections over 2021 Q4-2023Q4. The ECB projections show calendar-year average inflations rates over 2021-23.

Investment themes

1 The new nominal

- The powerful economic restart is broadening, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- We expect the Fed to start normalizing policy rates in 2023, a much slower pace than market pricing for lift-off in 2022 indicates. The market's lack of confidence in the Fed's commitment to its new framework poses a risk of tighter financial conditions in the near term. We would anticipate this uncertainty to dissipate over time – assuming the central bank regains control of its narrative – paving the way for us to lean even more tactically pro-risk.
- The European Central Bank has set its inflation target at 2% in the medium term but rejected an average inflation targeting framework. We see this as part of an ongoing policy evolution, and see near-term policy changes as unlikely. The ECB also said it would include climate change considerations in monetary policy operations.
- **Tactical implication**: We go overweight European equities and inflation-linked bonds. We cut U.S. equities to neutral.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is already a distinct pole of global growth. We believe it is time to also treat it as an investment destination separate from EM and DM. Growth in China is starting to slow at the same time the policy stance is relatively tight. The regulatory crackdown on dominant companies is ongoing. We see these as key aspects of China's efforts to improve the quality of growth.
- China's central bank unexpectedly announced a decision to cut the reserve requirement ratio, or the amount of cash banks must hold as reserves, to support economic growth that appears to be losing steam. We still believe the government will maintain its broadly hawkish policy preference to stay focused on the quality of growth.
- We could see times when markets become concerned that China's policy setting might be excessively tight. That points to downside risks in the short term. China is pushing through reforms that could weigh on the quantity of growth in the near term but potentially improve the *quality* in the long run.
- **Tactical implication:** We break out China from EM with a neutral stance on equities and an overweight to debt.
- **Strategic implication:** Our neutral allocation to Chinese assets is multiples larger than typical benchmark weights.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of prices of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

July 22 ECB policy meeting

July 23 Flash purchasing managers' index (PMI) for the U.S., euro area and UK

Investors will focus on the ECB's first policy meeting after its strategic review was published. We expect an update of the central bank's forward guidance on its monetary policy decisions to reflect its shift to a symmetric 2% inflation target, though we don't expect updated growth or inflation forecast until September. Global PMI data will shed some light on the ongoing restart in activity as growth momentum shifts from the U.S. to Europe and Japan.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our 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 indices. 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 quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballast with yields near lower bounds. 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 – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
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 and not suitable for all investors.

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

	Asset	Underweight	Overweight	
Equities	United States			We turn neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We upgrade European equities to overweight on the back of the broadening restart. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We turn neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We upgrade Japanese equities to neutral. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			While overweight on a strategic basis, we see near-term risks. Growth is slowing at the same time as policy stance is tight – and may not respond in a timely way as authorities focus on the quality of growth. The anti-monopoly clampdown is ongoing.
Equities	Emerging markets			We downgrade EM equities to neutral. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We downgrade Asia ex-Japan equities to neutral. The anti-monopoly clampdown in the heavyweight Chinese tech sector and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We add to our underweight on U.S. Treasuries, primarily on valuations. We see the balance of risks tilting toward gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We turn overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We initiate a view on Chinese government bonds with an overweight. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We remain underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We downgrade high yield to neutral after the asset class' strong performance. Spreads are now below where we see high yield as attractively valued. We prefer to take risk in equities.
Fixed Income	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.
Fixed Income	Emerging market – local currency			We downgrade to neutral and see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring, in our view.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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