Weekly commentary

BlackRock

July 26, 2021

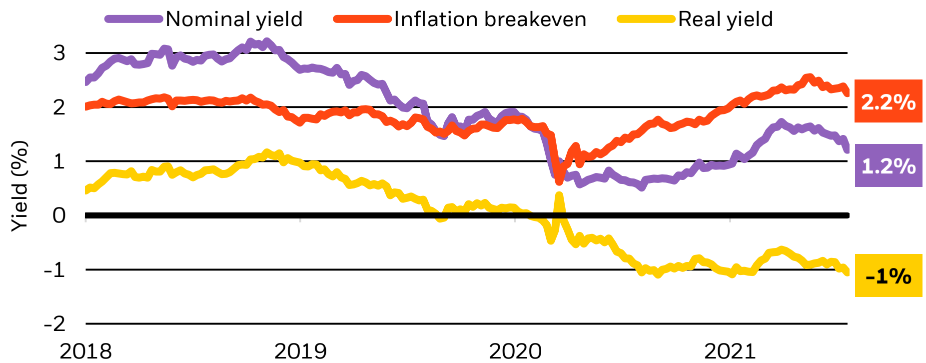
Taking advantage of volatility

- We could see more temporary risk-off episodes in light summer trading, and would view them as opportunities to re-adjust portfolios to a pro-risk stance.
- The European Central Bank delivered a dovish tilt in its guidance on interest rates, likely to be followed by an increase in its asset purchases.
- All eyes will be on the Federal Reserve's policy meeting this week, with the central bank unlikely to flag an imminent tapering of asset purchases.

Market volatility is on the rise, as worries about new virus strains have been exacerbated by stretched positioning and light summer trading. Recent swings in market sentiment reflect the unusually wide range of potential outcomes beyond the current economic restart, in our view. Market overreactions may create opportunities to readjust portfolios to a pro-risk stance as we maintain high conviction in our *new nominal* investment theme that implies low real yields.

Negative real yields underpin equities

U.S. 10-year Treasury yield breakdown, 2019-2021



Sources: BlackRock Investment Institute, with data from Refinitiv DataStream, July 2021. Notes: The purple line represents the nominal 10-year U.S. Treasury yield. The yellow line is the real, or inflation-adjusted, yield. The red line is the 10-year breakeven inflation rate, or the average inflation rate over the next decade implied by the pricing of Treasury Inflation-Protected Securities. Indexes are unmanaged. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest in an index.

Market sentiment has been swinging between extremes: One week the concern is runaway inflation; the next it's the prospect of a deflationary spiral. Most recently, bond markets appear to have ignored the latest strong U.S. employment and inflation data, and are focusing more on virus fears. Real, or inflation-adjusted, yields have dropped back toward historic lows, as the chart shows. The drop in nominal yields was likely exacerbated by foreign buying and short covering – or investors force to close out bets that yields would head higher. Shifting sentiment drove equity market volatility too - with large sectoral moves that quickly reversed.

The big picture: We believe these swings are to be expected, given the wide range of potential outcomes beyond the current restart of economic activity. In a noisy and unprecedented economic restart, having an anchor is all the more important. We stick to our *new nominal* investment theme: Major central banks are slower to respond to rising inflation than in the past, keeping nominal bond yields lower and real rates negative – a positive for risk assets.

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BlackRock **Investment** Institute

We believe the powerful restart of economic activity remains the key story for markets, and it's too early to make the determination that new virus strains will derail this. The evidence on vaccines is still consistent with their expected effectiveness, in our view, as reflected in hospitalizations significantly lagging the recent rise in cases due to the delta variant. Rising cases in the U.S. are to be expected – given the swift reopening and the emergence of the delta variant. The increase in cases in Europe has come quicker than many foresaw, yet pressure on hospitals is limited so far. The UK remains a test case to monitor -- and we are watching for a decline in the rate of growth of new cases after a recent spike. Asian and emerging market economies struggling with vaccination rollouts are suffering most in terms of health outcomes and mobility restrictions. Yet vaccines remain the way out, barring vaccine-resistant variants or new evidence on vaccine effectiveness, in our view. Stay up-to-date with our Covid tracker.

While virus dynamics are uncertain, we remain confident that the policy paradigm has changed: many central banks are now attempting in different ways to overshoot inflation targets to make up for past misses. Our analysis suggests the drop in yields since May was primarily due to a decline in the term premium – the additional compensation that investors demand for moving further out the yield curve in duration. This represents a partial unwinding of a spike in the term premium seen since mid last year. We have also seen a reversal in market expectations of the U.S. "terminal" rate – or the neutral rate consistent with the Fed's objectives. Markets are pricing in around four quarter percentage point rate hikes by 2025, roughly half what they priced in April – moving back toward our *new nominal* theme.

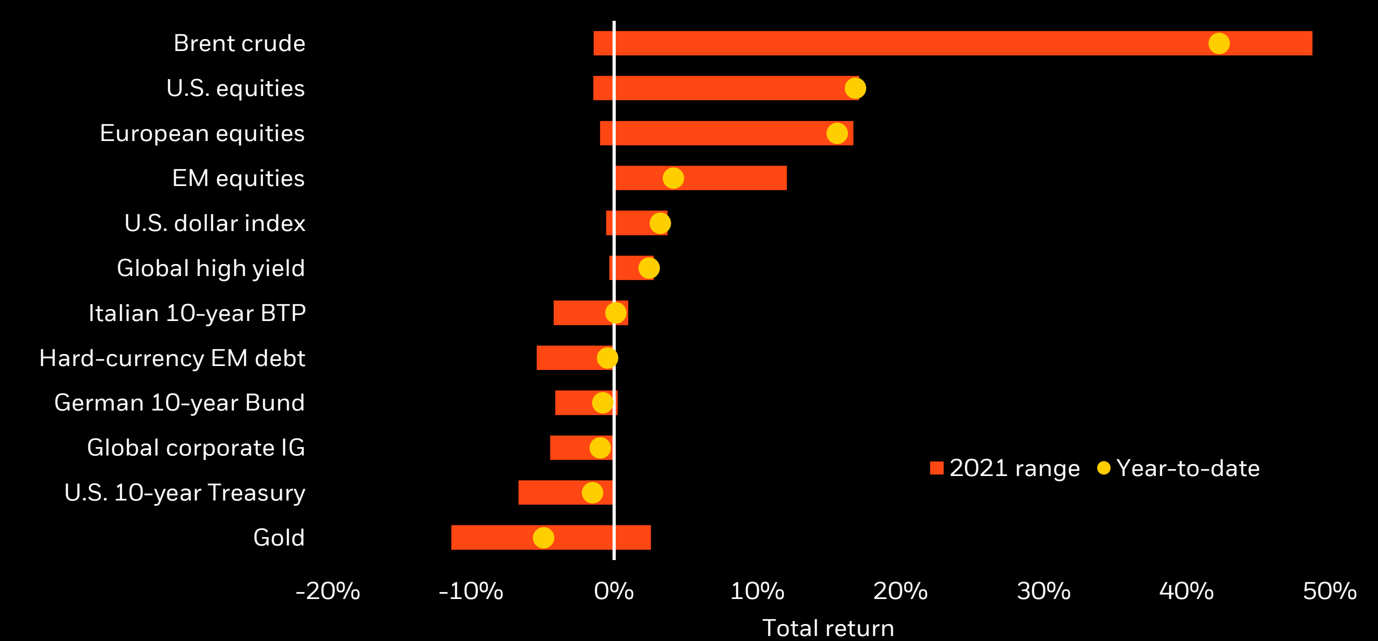
The bottom line? We believe the economic restart is real – but it is a restart, and will eventually taper back to the pre-covid trend. We see nominal yields rising far less in response to inflation than during similar episodes in the past. Yet still believe the direction of travel should be higher for nominal yields – and this is why we remain underweight Treasuries and government bonds overall, both on a tactical and strategic basis. Negative real interest rates provide a positive backdrop for equities, in our view. Markets may overreact to economic data and other news flow with thin liquidity in the summer, amid an unusually wide range of macro outcomes, in our view. Yet for now we see the restart intact and the *new nominal* holding – and would consider any temporary sell-offs as opportunities to readjust portfolios into a pro-risk stance.

Market backdrop

Risk assets have rebounded from their swoon earlier in the month, with bond yields bouncing off lows. Such sharp price swings are the latest example of markets overreacting while grappling with the unusually wide range of potential outcomes that lie beyond the restart of economic activity. The ECB tweaked its forward guidance by making a lift-off in rates conditional on inflation durably reaching 2%, well within its forecast horizon. This is consistent with our *new nominal* theme, which holds that central banks will be slower to raise rates in the face of rising inflation than in the past.

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.

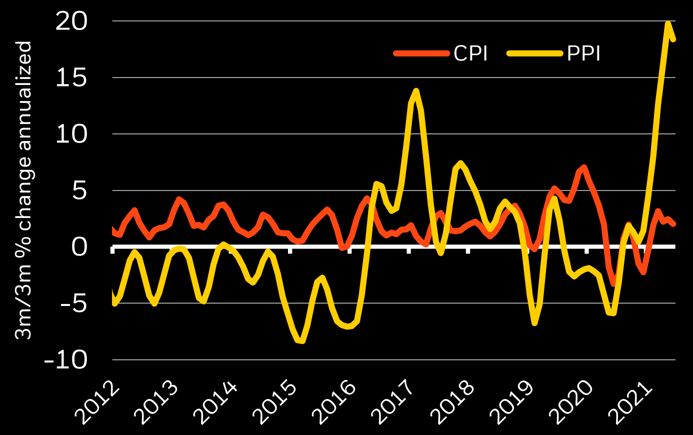
Macro insights

China's recent policy loosening – a cut in reserve requirements for most banks – was likely a preemptive move to cushion an expected further slowdown in economic growth, in our view. Further easing may lie ahead, and the tone of an upcoming Politburo meeting, chaired by President Xi Jinping, will provide an important signal. If the president endorses a looser policy stance, the People's Bank of China (PBOC) looks likely to follow their guidance and loosen policy further. With inflationary pressures easing and what appears to be limited passthrough from producer prices to consumer prices – see chart – policymakers have some room to act.

Yet we expect only limited short-term policy easing and see the PBOC remaining hawkish overall. Why? The focus remains on the quality of growth over quantity and a hawkish bias is central to that. Indeed, following the decision on the reserve requirement rate, the PBOC stated that the cut did not represent a fundamental change in the policy stance, potentially signaling that it may have had some reservations about the move. See our macro insights hub.

China inflationary pressures falling

China consumer price index and producer price index, 2012-2021



Sources: BlackRock Investment Institute, CNBS (China National Bureau of Statistics), with data from Haver Analytics.

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 ECB tweaked its forward guidance after having recently set its inflation target at 2% in the medium term but rejecting an average inflation targeting framework. The central bank said it would keep policy rates on hold until it had seen "inflation reaching 2% well ahead of the end of the projection horizon and durably for the rest of the projection horizon." We see this likely to be followed by an increase in the ECB's asset purchases later this year.
- **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 27	U.S. consumer confidence	**July 29**	U.S. second-quarter GDP
July 28	FOMC policy decision	**July 30**	Euro area second-quarter GDP and inflation

All eyes will be on the Fed this week. We see the central bank likely upholding its accommodative policy stance as the strong activity restart in the U.S has led to unusual supply and demand dynamics and volatile near-term growth and inflation data. We don't see the Fed discussing a tapering of asset purchases imminently, and a discussion later this year doesn't mean a lift-off from near zero policy rates is close, in our view.

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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