Weekly commentary

June 7, 2021

BlackRock.

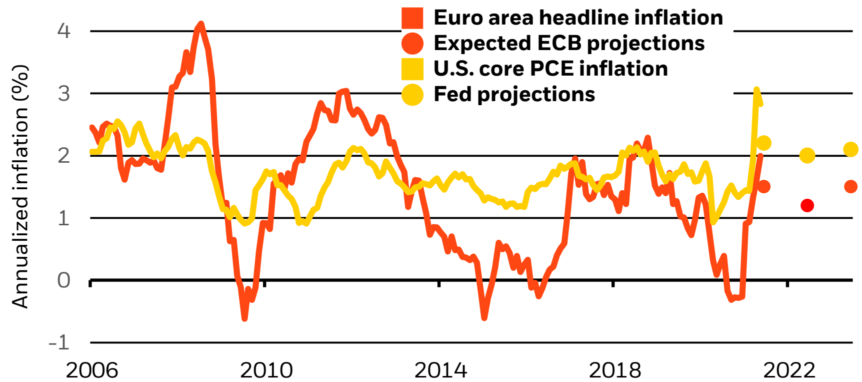
ECB – keeping up the pace

- We expect the European Central Bank (ECB) to maintain its current pace of asset purchases even though the economic restart is gaining momentum.
- U.S. nonfarm payrolls growth picked up in May. We caution against extrapolating too much from erratic near-term data amid a powerful restart.
- U.S. inflation data will also be in focus this week. A high core consumer price index (CPI) reading could fuel talks of tapering by the Federal Reserve.

We expect the ECB to maintain its current pace of asset purchases even as the economic restart gains traction. We wouldn't view a decision to slow purchases as a hawkish policy signal, as the ECB is focused on keeping financing conditions easy. This, and a Federal Reserve that we see keeping policy easy, provides a positive backdrop for risk assets including European equities, in our view.

Chart of the week

Actual and projected euro area and U.S. inflation, 2006-2023



Sources: BlackRock Investment Institute, the Federal Reserve Board and Bureau of Economic Analysis, with data from Refinitiv, June 2021. Notes: The orange dots represent consensus expectations for ECB staff inflation projections due this month. Fed projections refer to the Fed's Summary of Economic Projections from March 2021. Euro area headline inflation refers to the Harmonized Index of Consumer Prices (HICP). U.S. core PCE inflation refers to the personal consumption expenditures price index, excluding food and energy.

Financing conditions in the euro area tightened late last year and in the first quarter of 2021, but have since stabilized and still appear supportive of growth. Yet the region's inflation outlook – the primary consideration in the ECB's policy decisions – remains weak. Consensus expectations see ECB staff projections due this week showing 2023 inflation still materially undershooting the bank's target of below but close to 2%. In contrast, the U.S. core personal consumption expenditures (PCE) inflation – the Fed's preferred inflation measure – has shot up above the 2% target. It will likely hover at or just above target over the next two years, according to the Fed's latest Summary of Economic Projections. See the chart above. This underpins our expectation for the ECB's policy support to stay put – regardless of its decision on the pace of asset purchases this week. In addition, we caution against reading too much into strong near-term growth data. We are experiencing an economic restart rather than a typical business cycle recovery; the usual business cycle playbook doesn't apply, in our view.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BlackRock **Investment** Institute

We expect the ECB to maintain its current pace of asset purchases under the pandemic emergency purchase program (PEPP) this week, despite a likely upgrade to its growth projections. The central bank is squarely focused on maintaining easy financing conditions. An unwarranted tightening in financing conditions, partly as a result of rising U.S. bond yields earlier in the year, prompted the ECB to quicken the pace of its asset purchases in March. Since then, the euro area has been catching up on activity restart, amid still supportive financing conditions.

Even if the ECB were to reduce its pace of asset purchases, we would view this as an operational decision rather than a policy decision. The ECB has committed to maintain its policy support for the duration of the pandemic crisis – at least until early 2022. Beyond that, we expect policy support to remain in place given an outlook that points to inflation staying far below target, with further asset purchases likely conducted through the extension of other asset purchase programs.

We see both the Fed and ECB likely upholding their accommodative policy stances. Inflation – not the near-term growth outlook – is key to the Fed's rate outlook under its new policy framework, in our view. The strong activity restart in the U.S. has led to unusual supply and demand dynamics, and volatile near-term growth and inflation data. Long-term U.S. government bond yields have risen this year, but the rise has been more muted than typically seen in response to rising inflation and growth expectations in the past – in line with our *new nominal* investment theme that sees a lower future path of short-term interest rates than markets are pricing in even amid rising inflation. We don't see the Fed discussing a tapering of asset purchases imminently – and a discussion later this year doesn't mean a liftoff from near-zero policy rates is close, in our view. The case for tapering – or monetary policy normalization – in the euro area is even weaker, in our view.

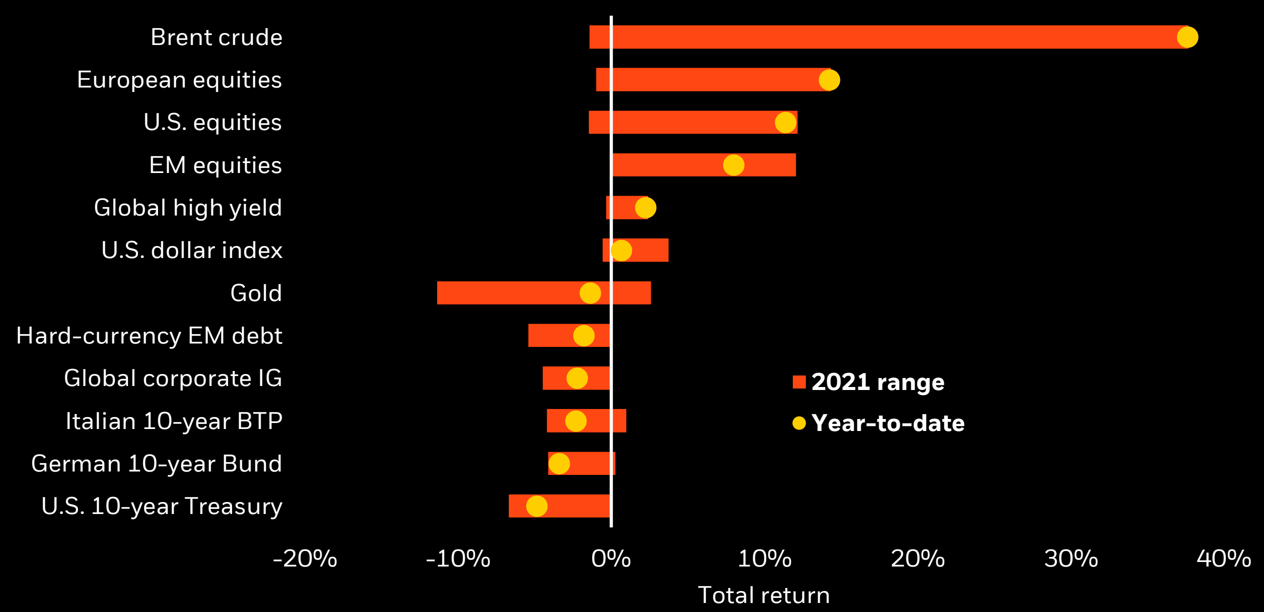
The bottom line: We see the ECB's commitment to accommodative policy as supporting our pro-risk stance over the tactical horizon as the reopening broadens out. We upgraded our tactical view on European equities to neutral in February, and are seeing more reasons to be optimistic about this asset class for the next six to 12 months. Yet we see a risk that markets could misinterpret an operational decision to slow the pace of purchases as a more hawkish view on policy stimulus, and we would view any spread widening in euro area peripheral bonds in such an event as a buying opportunity.

Market backdrop

U.S nonfarm payrolls growth picked up in May, albeit by less than expected. Economic data have been erratic, and we expect more of the same as economies restart amid pent-up consumer demand and supply shortages. We advocate looking through near-term market volatility and remain pro-risk, predicated on our belief that the Fed faces a very high bar to change its easy monetary policy stance.

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 June 3, 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), spot gold, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

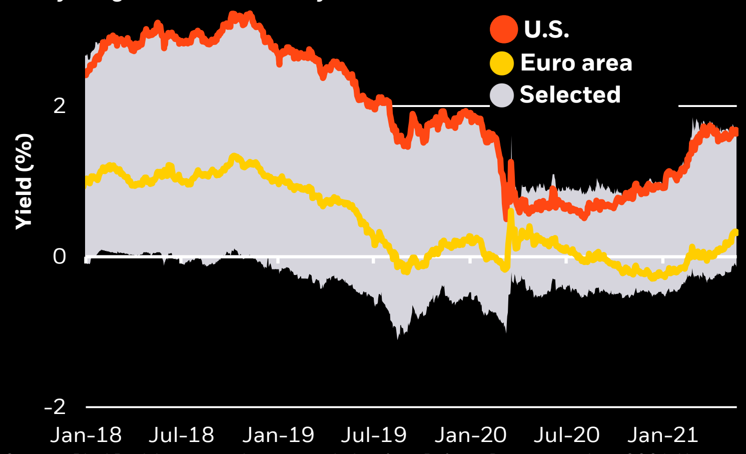
Macro insights

Long-term government bond yields have risen in the euro area, as in many other developed economies. Rising yields – while well below the levels of U.S. yields – partly reflect growing optimism about the economic restart in the region. See the chart. Euro area sovereign yield spreads have also widened. The yield spread between 10-year Italian and German government bonds widened to over 120 basis points in May, before narrowing to near post-pandemic lows of around 90 basis points.

A sharp increase in U.S. yields in the first quarter helped drive up yields in the euro area – and motivated the ECB to ramp up the pace of asset purchases in March. Recent ECB work breaking down the drivers of euro area term premia, the compensation investors demand for holding longer duration bonds, points to increasing global spill-overs, particularly from the U.S. We believe the ECB may be more inclined to lean against any tightening of financing conditions triggered by rising U.S. term premia than by stronger European data. See our macro insights hub for more.

Rising bond yields

Ten-year government bond yields, 2018-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, June 2021. Notes: The gray area shows the range of 10-year government bond yields of a selected group of developed market economies including Australia, Canada, the euro area, Japan, Sweden, Switzerland, the U.K. and the U.S. The euro area yield refers to a GDP-weighted average yield.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart – with the euro area catching up - 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 recent policy meetings. 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 rise in nominal government bond yields this year is justified and reflects markets awakening to a strong, vaccine-driven activity restart combined with historically large fiscal stimulus.
- 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. Pending legislation in the U.S. would direct large-scale investment to meet the China challenge. We see a case for greater exposure to China-related assets for potential returns and diversification – and view them as core strategic holdings that are distinct from EM exposures.
- 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.
- Momentum is growing at the G20 for a global minimum tax that would reduce the ability of multinationals to shift profits to low-tax jurisdictions.
- **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. We see a risk of social unrest.
- **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

June 9	China inflation
June 10–17	China total social financing and new yuan loans
June 10	ECB monetary policy meeting; U.S. consumer price index
June 11	University of Michigan Surveys of Consumers

Markets will focus on U.S. inflation data, in addition to the ECB's policy meeting. A high core CPI number – after a much stronger-than-expected 3% reading in April – could fuel more talk of the Fed tapering asset purchases, though we don't see the Fed discussing a potential tapering imminently.

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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	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.
Equities	Value			We are neutral on value despite recent outperformance. 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.
Equities	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.
Equities	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.
Equities	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
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.
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 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.
Fixed Income	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.

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