Weekly commentary

BlackRock

July 27, 2020

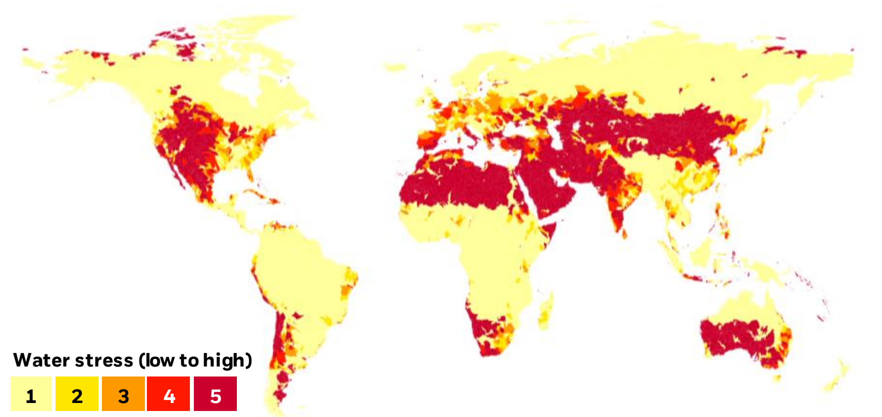
Real resilience in sustainability

- The tectonic shift toward sustainability is gaining pace. We highlight an underappreciated climate-related risk to portfolios: water stress.
- Negotiations have kicked off over the size and make-up of a new U.S. fiscal package as key benefits are set to expire and states face budget shortfalls.
- U.S. consumer confidence is in focus this week as the fiscal cliff nears and the pandemic's spread in Sunbelt states is starting to affect economic activity.

We have pointed to a tectonic shift toward sustainability, and how the global pandemic has accelerated this process. This highlights the need for *real resilience* in portfolios to guard against risks ranging from vulnerable global supply chains to the intensifying effects of climate change. We see room for sustainable assets to outperform in the long transition to a low-carbon world.

Chart of the week

Projected water stress around the world by risk zone, 2030



Source: BlackRock Investment Institute and BlackRock Sustainable Investing, with data from the World Resources Institute, June 2020. Notes: WRI defines water stress as the ratio of total water withdrawals to available renewable surface and groundwater supplies. Higher water stress levels indicate more competition among water users. Water withdrawals include those from irrigation, livestock, industrial use, and domestic sectors. Available supplies capture natural runoff as well as the impact of upstream water use and dam operations on downstream water availability. Water stress is assessed on WRI's five point scale, ranging from "low" to "extremely high" (1 to 5). For illustrative purposes only. Forward-looking estimates may not come to pass.

Water stress – when demand for water exceeds supply – is an underappreciated risk that cuts across regions, asset classes and sectors. It is a component of growing climate-related risks such as hurricanes, wildfires and flooding, and threatens public health, production facilities and global supply chains. Large cities will need to strengthen their water infrastructure. Within a decade, much of the world will lie in regions of high water stress, projections by the World Resources Institute show. Northern Africa is one high-risk zone, as seen by the red tones in the chart above. The risks also have geopolitical dimensions, as highlighted by a recent spat over a large hydroelectric project in Ethiopia that neighbors Egypt and Sudan fear could reduce water availability. Combining climate modeling with the geolocation of physical assets can help investors get a better handle on the risks to companies and their human capital.

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BlackRock **Investment** Institute

Companies in water-stressed locations may need to spend more to source water, to raise water efficiency and to meet more stringent environmental regulations. For details, see our new publication Troubled waters. Regulators are zeroing in on water-related risks: A recent European Central Bank report included water stress among the physical climate risks it may require financial institutions to manage and disclose.

The causes of water stress are varied. Population growth and urbanization increase demand for water and strain resources. At the same time, climate change is shifting the distribution of water supply by disrupting precipitation patterns. The agricultural, textile, energy, industrials, chemicals, pharmaceutical and mining industries account for around 70% of freshwater usage globally, according to the Carbon Disclosure Project's 2018 Global water report. The risks from water stress are most acute in water-intensive industries. In the agricultural sector, reduced water availability for irrigation can lower crop yields. In electric utilities, water is critical for cooling thermal power plants. In real estate, climate-related risks such as water stress could accelerate a tenant preference for "green" buildings. And the creditworthiness of some countries, states and municipalities facing water shortages could come under threat due to rising costs to fortify water resources.

We believe increased asset flows into sustainable investing strategies in 2020 are part of a tectonic shift that could last decades. A societal shift toward sustainability and growing awareness of related risks are behind these flows. Climate-related events such as extreme weather are already causing real financial damage, as we detailed in Getting physical in April 2019. We believe many of the risks are not yet priced in by financial markets. A strategic tilt toward assets that score highly on sustainability may mitigate the risks, helping provide *real resilience* in portfolios.

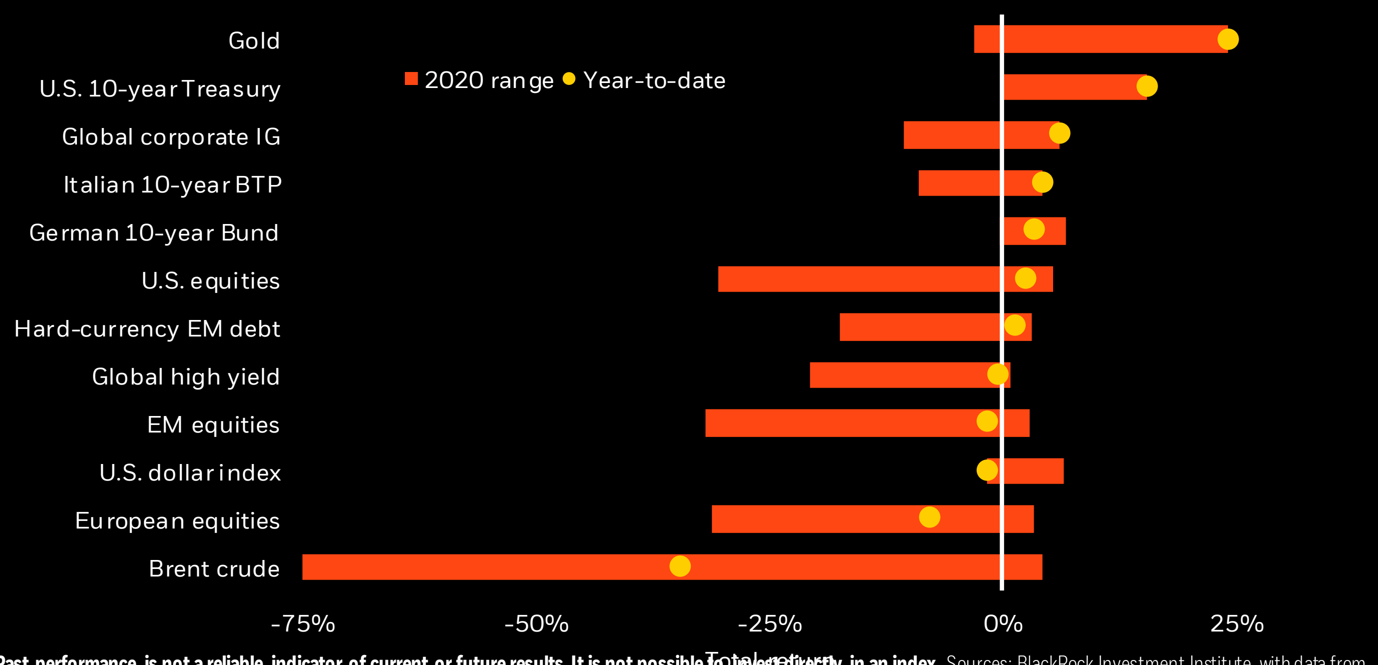
Bottom line: Companies resilient to water stress and other climate-related risks may fetch a premium in the transition to a low-carbon economy. Better understanding and quantifying the risks can help investors mitigate exposures and potentially exploit any mispricing. Investors today have more options than ever before to integrate sustainability into portfolios. This includes thematic investing that targets specific sustainability trends – and new benchmarks that offer broad market exposures while providing a tilt to sustainability.

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. Wrangling over the size and makeup of a new U.S. fiscal package has started as key benefits are set to expire 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, July 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.

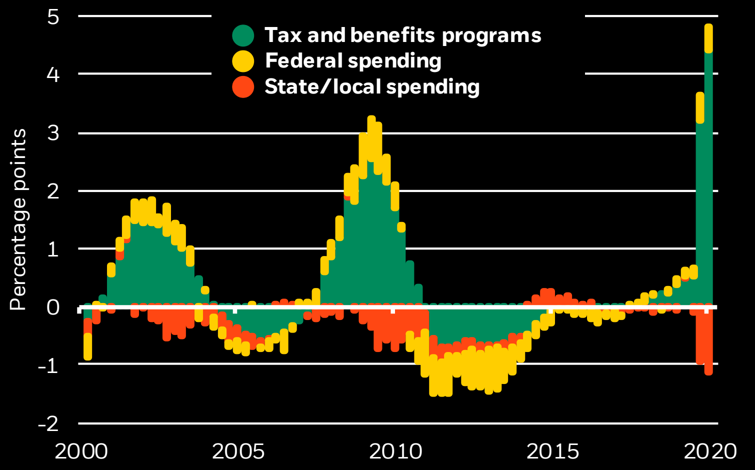
Macro insights

The U.S. is headed toward a fiscal cliff unless Congress agrees on fresh stimulus in coming weeks. Key elements of the current stimulus to cushion the virus shock could be curtailed prematurely, in our view. Importantly, state and local governments could be forced to cut back on spending to balance their books just when support is needed most.

The Center on Budget and Policy Priorities estimates state and local tax revenue shortfalls of up to 10% in 2020, and 10-20% in some states in 2021. The cumulative shortfall could total $555 billion through 2022. State governments could be forced into painful austerity, and there is already growing evidence of public sector employees being put on furlough. State and local austerity weighed significantly on GDP in the aftermath of the global financial crisis, and the Brookings Institute's Hutchins Center projects an even sharper fiscal drag this year. See the *State austerity* chart. State and local government employment has fallen by around 5% from pre-Covid levels and – unlike private payrolls – has not rebounded.

State austerity

Contributions to real U.S. GDP growth, 2000-2020



Source: BlackRock Investment Institute and the Hutchins Center on Fiscal and Monetary Policy, with data from Haver Analytics. Note: The bars show the estimated fiscal impulse from federal and state and local spending, and tax and benefit programs, as the percentage point contribution to real GDP growth on a four-quarter moving average. The 2020 bars are Hutchins Center estimates. Forward looking estimates may not come to pass.

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. Additional unemployment benefits and small business support are set to expire, and states may be forced into austerity to close large budget shortfalls. We could see a $1-1.5 trillion fiscal package that extends some (but not all) federal stimulus measures through late-2020.
- **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

July 28	U.S. consumer confidence	**July 30**	U.S. Q2 GDP
July 29	Federal Reserve rate decision and media briefing	**July 31**	China NBS Manufacturing PMI; euro area Q2 GDP

U.S. consumers confidence is in focus this week amid a sharp rise in virus infections across many states. The pandemic's spread is starting to weigh on mobility – a key gauge of economic activity, as detailed in our Midyear Outlook – as more people practice social distancing. The number of airport travelers has started to fall again and restaurant bookings have been flat. GDP data this week will show how hard the virus hit the U.S. and euro area economies in the second quarter.

Directional views

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