Weekly commentary

BlackRock

Sept. 14, 2020

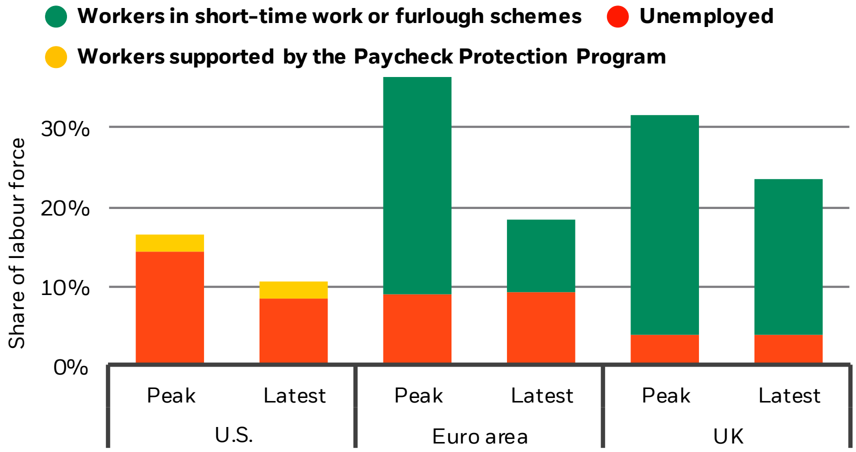
Why we stay moderately pro-risk

- The improving macro backdrop, a strong risk rally and rising volatility leave us moderately pro-risk over coming months, with a preference for credit.
- The outcome of negotiations of a new U.S. fiscal package looks increasingly binary: a sizable fiscal package or nothing at all before the November election.
- Markets will watch for any details of the Federal Reserve's new average inflation targeting framework as the central bank holds its policy meeting this week.

The broad macro backdrop has been improving, risk assets have rallied a long way, and increasing market volatility points to risks that investors will need to navigate as the U.S. presidential election draws closer. All this leaves us moderately pro-risk as we head into year end, with a preference for credit.

Chart of the week

Labor market support in selected developed economies, September 2020



Sources: BlackRock Investment Institute, with data from Haver Analytics, BLS, Eurostat, ONS, DARES, Spanish Labor Ministry, INPS, Autor et al (2020), September 2020. Notes: The latest estimates are for August in the U.S, July in the euro area and June in the UK. Official estimates of workers still covered by the U.S. PPP scheme are not publicly available, so we used the estimate published by Autor et al for June as the latest. Peak bars show the levels at the point where the take-up of furlough schemes was at its highest from March 2020. Euro area is based on an average of Germany, France, Italy and Spain.

We see localized restrictions – rather than a return to national lockdowns – as the main virus control approach over coming months. Fatality and hospitalization rates *per infection* have dropped even with higher case counts. Against this backdrop we use three signposts to assess the recovery: activity, policy support, and permanent scarring. The restart has so far surprised on the upside. This reaffirms our view that the cumulative shock from the virus should be a fraction of that from the global financial crisis, even though the harder part of the recovery lies ahead. Policy is still supportive of the restart, as illustrated in the chart by the fiscal support measures provided to key labor markets. Europe's short-time work or furlough programs have supported a large proportion of the labor force, as the green bars show. The U.S. has focused on additional unemployment benefits. Both the UK and U.S. face risks stemming from an early end to such programs.

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Monetary and fiscal policy have played a key supporting role for the private sector. U.S. jobs data have pointed to a further fall in the unemployment rate and an increase in labor participation. In Europe, labor market policies have kept a lid on the increase in unemployment. Yet they may delay the inevitable adjustment of some industries to a post-Covid world and weigh on productivity and wages in the long term. The key recent shift in monetary policies: The Federal Reserve has adopted an average inflation targeting framework and shifted to using "shortfalls" from full employment as key to assess labor market conditions. This raises the likelihood of higher medium-term inflation – and introduces other risks such as political challenges that may make it harder for the Fed to fight future inflation episodes.

So far we have seen limited evidence of permanent damage to the economy, even though many firms and individuals are going through a painful period of readjustment. U.S. bankruptcy filings for large firms rose sharply through July but have fallen in August. Some U.S. firms use bankruptcy proceedings to protect themselves from creditors while structuring for a post-Covid world. In Europe, bankruptcy data have been distorted by the temporary relaxation of requirement for unviable firms to cease trading. Euro area bank lending to non-financial firms is still growing strongly, providing companies with a lifeline. Yet we see risks that the policy support could produce unviable "zombie firms."

The recent U.S. stock market selloff may be triggered by the unwinding of crowded positions in tech – this year's best-performing sector. It also highlights some fundamental risks investors need to navigate in coming months, such as the increasing dominance of tech stocks in the market. Policy exhaustion is also a risk. A premature retrenchment could hamper the activity restart just as we get to the harder part of it. This might open the door to more considerable scarring of the real economy. The virus spread may pick up pace when the Northern Hemisphere enters colder seasons. The U.S. election in November also looms large, with the potential for drastically different implications on policy and markets.

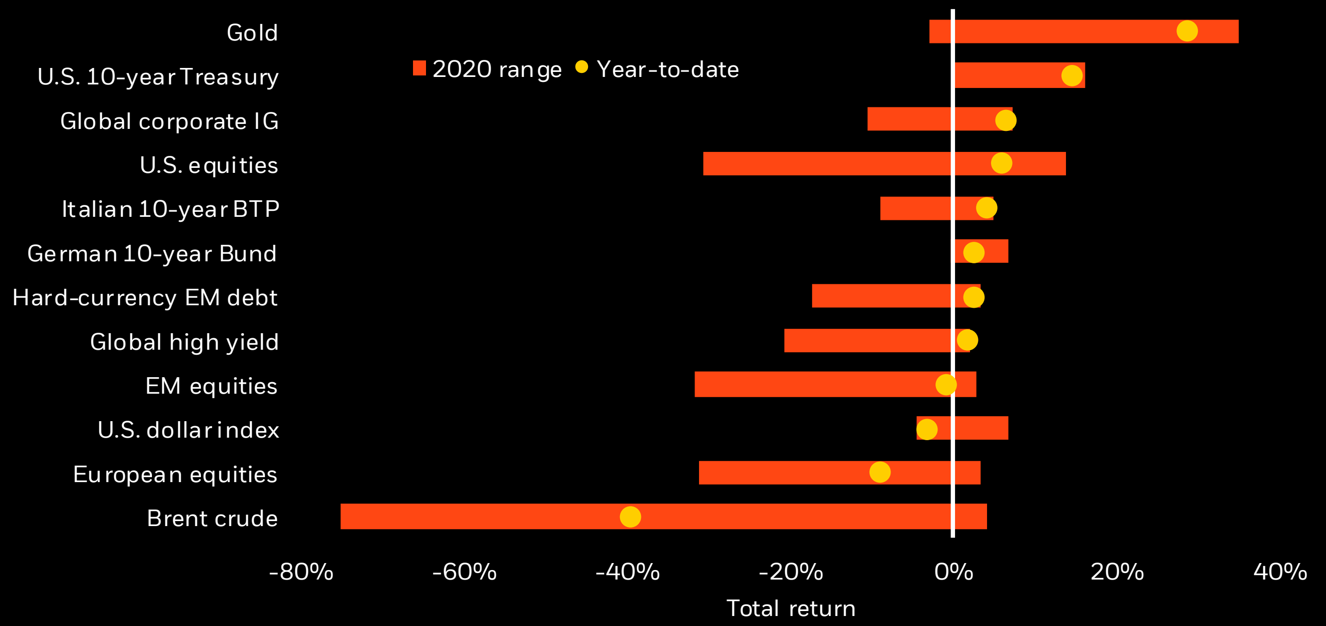
The bottom line: We remain moderately pro-risk over the next six to 12 months. We prefer credit over equities tactically, as stocks have become more expensive relative to credit. In credit we favor high yield for its income potential and are neutral on investment grade. In equities we prefer the euro area market due to its cyclical exposure. We are underweight emerging markets outside Asia and neutral on EM Asia as the latter has fared better in both virus control and market performance.

Market backdrop

Activity has started to normalize around the globe, albeit with renewed localized lockdowns to contain virus clusters. Market volatility is returning after months of steady advances in risk assets. Valuations have risen, and we could see greater volatility as a result, especially as the U.S. election closes in. A contributing factor: The outcome of negotiations of a new U.S. fiscal package appears increasingly binary: a sizable package or nothing at all before the election. In addition, the pandemic is still spreading in many countries, and U.S.-China tensions have escalated.

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, September 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 therest 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.

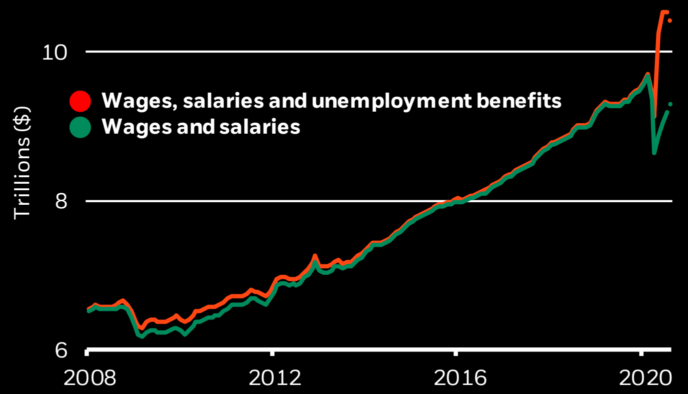
Macro insights

Monetary and fiscal policy has played a key role in propping up the private sector. Fiscal support is especially important for the labor market, with different manifestations across economies. Europe has supported workers with short-term work or furlough programs, while the U.S. has focused on paying enhanced unemployment benefits. The chart on the right illustrates the key role of unemployment benefits in bridging the income gap in the U.S. The U.S. labor market is slowly improving. Most of the increase in unemployment is considered temporary, and the overall unemployment rate has fallen from peaks and labor participation has gone up.

We still see risks of a premature withdrawal of policy support. The additional federal unemployment benefits expired in July and little progress has been made to extend the program. We now see the outcome of negotiations of a new fiscal package as increasingly binary: either a sizable package or nothing at all before the November election.

Bridging the gap

U.S. wages and unemployment benefits, 2008-2020



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and the U.S. Treasury, with data from Haver Analytics, Sept. 2020. Note: The green line shows annualized wages and salaries for U.S. workers. Data up to July are from the BEA personal income report. The dotted figure for August is projected using the monthly change in income calculated from the August employment report. The orange line combines wages, salaries and unemployment insurance (UI). The UI data up to July are from the BEA report, and projected for August based on high frequency data from the Daily Treasury Statement.

Investment themes

1 Activity restart

- The activity restart has broadened. Yet it is moving at different speeds across countries, driven by differences in virus dynamics - stalling or retrenching in countries that experienced an increase in virus infection rates. An unprecedented joint monetary-fiscal policy response is providing a bridge for disrupted income streams.
- Evidence of permanent damages is limited so far for economies as a whole but the adjustment to a post-Covid world could be painful for some contact-sensitive sectors.
- We see localized restrictions as the main virus control approach over coming month, and a return to full national lockdowns as unlikely. Fatality and hospitalization rates per infection have dropped even with higher case counts.
- **Market implication**: We are moderately pro-risk, and express it in an overweight in high yield – in both strategic and tactical portfolios. We have a preference for cyclical assets in Europe.

2 Policy revolution

- Closer fiscal-monetary policy coordination, the Federal Reserve's new policy framework, and other structural changes accelerated by Covid-19 such as deglobalization point to a higher inflation regime in the next five years.
- 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. Yet in the medium term the blurring of monetary and fiscal policy could bring about upside inflation risks. It's crucial to have proper guardrails around policy coordination, as we discuss in Policy Revolution.
- Central banks are signaling a greater tolerance of higher inflation. The Fed has adopted a flexible version of average inflation targeting and shifted to using "shortfalls" from full employment as key to assess labor market conditions.
- The historic €750 billion European recovery plan 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.
- Fiscal stimulus fatigue is becoming a risk – especially in the U.S. – even as Europe has stepped up its fiscal support. Negotiations of new fiscal relief measures in the U.S. have stalled. The outcome appears increasingly binary: a sizable package or nothing at all before the election.
- **Market implication**: We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically we prefer high yield and see U.S. equities vulnerable to fading fiscal stimulus and the unwinding of crowded positions.

3 Real resilience

- Supercharged structural trends are changing the nature of portfolio diversification. We believe countries, sectors and companies will make a comeback as diversifiers in a more fragmented world, 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 are overweight the quality factor on a tactical horizon, favor assets with policy backstops, and generally prefer developed markets over the emerging world.

Week ahead

Sept. 15	German ZEW Indicator of Economic Sentiment; U.S. industrial production
Sept. 16	Federal Open Market Committee meeting ends
Sept. 17	Philly Fed manufacturing business outlook survey; policy meetings of Bank of England and Bank of Japan
Sept. 18	University of Michigan Surveys of Consumers

Central banks will be in the limelight this week. The Fed, in particular, will be a focus as it conducts the first monetary policy meeting after unveiling its new average inflation targeting framework. Any details on what the framework means in practice could have significant implications for inflation expectations.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2020

Asset	Strategic view	Tactical view	
Equities	**Neutral**	**Neutral**	We have turned neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We move to a modest underweight in DM equities and tilt toward EM equities. Tactically, we are also neutral on equities overall . We like the quality factor for its resilience and favor Europe among cyclical exposures.
Credit	**Neutral**	**+1**	We have turned neutral on credit on a strategic basis because we see investment grade (IG) spreads offering less compensation for any increase in default risks. We still like high yield for income. On a tactical horizon, we strongly prefer high yield for its income and more room for spread tightening. We are neutral on IG and underweight emerging market debt.
Govt bonds	**-1**	**Neutral**	The strategic case for holding nominal government bonds has materially diminished with yields closer to perceived lower bounds. Such low rates reduce the asset class's ability to act as ballast against equity market selloffs. We prefer inflation-linked bonds as we see risks of higher inflation in the medium term. On a tactical basis, we keep duration at neutral as unprecedented policy accommodation suppresses yields.
Cash		**Neutral**	We are neutral on cash. Holding some cash makes sense as a buffer against supply shocks that could 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 inherent uncertainties of some private assets keep us neutral overall.

Note: Views are from a U.S. dollar perspective, September 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

Change in view
Previous → New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, September 2020

	Asset	**Underweight**	**Overweight**	
Equities	United States			We are neutral on U.S. equities. 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 are overweight European equities. 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 keep Japanese equities at neutral. We see strong fiscal policy and public health measures allowing for rapid normalization.
	Emerging markets	■		We are underweight emerging market equities. 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 hold Asia ex-Japan equities at 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 are neutral on value. 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 hold min vol at neutral. The restart of economies is likely to benefit cyclical assets and reduce the need for defensive exposures.
	Quality		■ ■	We keep our strong overweight on 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 still 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 are 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 downgrade investment grade credit to neutral. We see little room for further yield spread compression, as we see deeper rate cuts and more asset purchases as unlikely as policy response. Central bank asset purchases and a broadly stable rates backdrop still are supportive.
	Global high yield		■ ●→■	We increase our overweight on high yield. We see the very high implied default rates as overly pessimistic, and high yield remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency	■		We are underweight 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 have downgraded local-currency EM debt to underweight. We see many EM countries as having insufficient capacity to rein in the virus spread and limited policy space to cushion the shock from the pandemic.
	Asia fixed income			We are 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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