

Weekly commentary

June 29, 2020

BlackRock

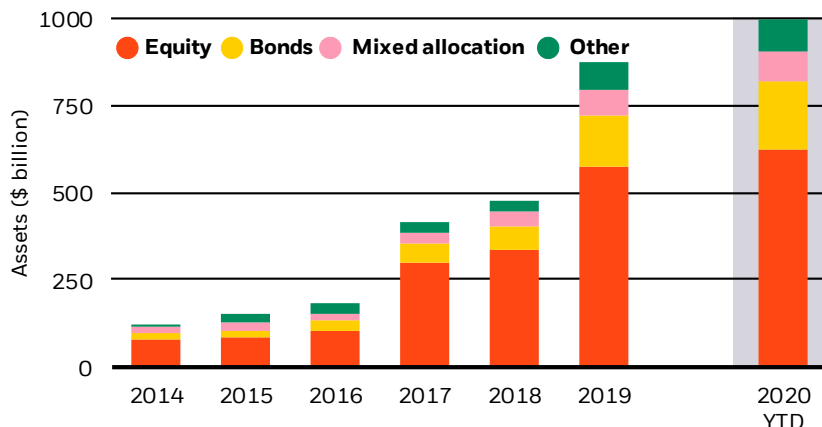
Our midyear outlook

- The virus shock is accelerating key structural trends. We update our three investment themes and investment views against this backdrop.
- We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen.
- Markets this week will focus on the latest U.S. employment data as well as on the virus case count and its implication on the economic restart.

The COVID-19 shock is accelerating structural trends in inequality, globalization, macro policy and sustainability. This is fundamentally reshaping the investment landscape and will be key to investor outcomes. Our [Midyear outlook](#) explains why the most important action investors need to take today is to review their strategic asset allocation to ensure portfolios are resilient to these trends.

Chart of the week

Assets under management at ESG-mandated funds, 2014-2020 YTD



Sources: BlackRock Investment Institute with data from EPFR, as of June 2020. Notes: The chart shows the global total assets under management at ESG-mandated funds. The "other" category includes money-market and alternatives funds. Data for 2020 through May 31, 2020.

The pandemic has supercharged a shift toward sustainability. Assets under management at environmental, social and governance (ESG)-mandated funds in the U.S. exceeded last year's record levels at the end of May, even as markets had sold off. See the chart above. Sustainable flows are in their early stages, in our view, and the [sustainability wave](#) will likely unfold over years and decades. We also believe markets still underappreciate the [potential economic damage caused by climate change](#), as well as related opportunities such as the long-term rise in renewable energy. The pandemic has brought some setbacks in sustainability-related trends. For example, some governments have paused efforts to curb plastic use. Yet we believe these setbacks are temporary, and the pandemic has thrown spotlight on the "S" in ESG, as issues such as employee safety and social purpose of companies come to the fore. We see sustainability rising above the mere labels of environment, social and governance. A focus on sustainability can help portfolios achieve greater resilience to shocks, in our view.



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BlackRock Investment Institute

The focus of the BlackRock Investment Institute's virtual – but no-less real – Midyear Outlook Forum in early June was decisively on longer-term trends. The COVID-19 shock has pushed the world harder against four key limits we identified at our November forum: inequality, globalization, macro policy and sustainability. We have revamped our three investment themes to reflect the changes. Our new macro view is captured by the “Activity restart” theme as economies reopen at different speeds. A “Policy revolution” is taking place to cushion the pandemic's shock, making this our second theme. Our third theme is “Real resilience,” as countries and sectors look set to make a comeback as diversifiers in a more fragmented world, offering resilience to real economy trends.

We highlight the importance of the “Real resilience” theme in particular. The structural shifts accelerated by the pandemic shock are already challenging the resilience of portfolios here and now. The chart on the previous page illustrated one such trend – a shift toward sustainable investing. Others include the intensifying U.S.-China strategic rivalry across multiple dimensions. In this increasingly bipolar world, investors need to balance the investment case for gaining exposure to both these engines of global growth, with possible investment restrictions on each side. We see structural portfolio resilience as much more than just relying on broad asset class correlations in public markets. It's making sure portfolios are well positioned at regional, country and company level to underlying themes.

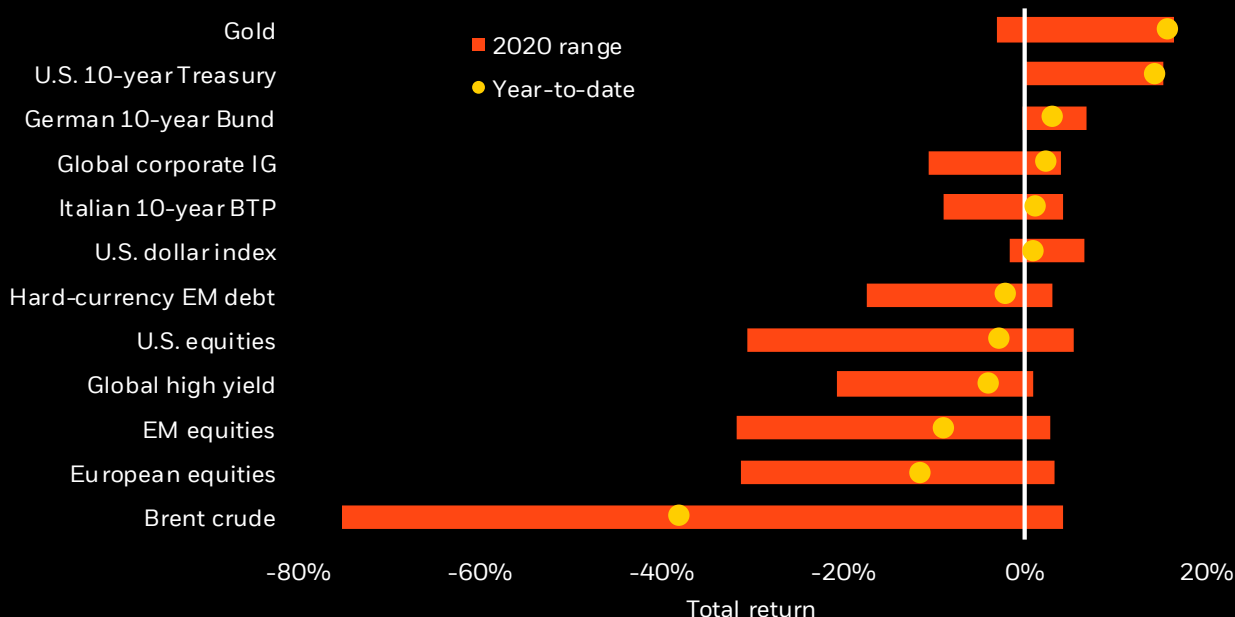
We believe what is needed today is a reassessment of the whole portfolio, not just a tweaking at the edges. On a strategic horizon, we highlight the fading role of nominal government bonds as their expected long-term returns fall into negative territory in developed markets. We instead prefer inflation-protected bonds as inflation risk builds up in coming years. We also view portfolio diversification as key, as return dispersion grows across regions, and within asset classes. On a tactical basis we maintain a modest pro-risk stance overall, and prefer credit to equities, favoring up-in-quality assets that have policy backstops and are higher up the corporate capital structure. We upgrade European equities to overweight, as we see the region as offering the most attractive exposure to any cyclical uptick due to its public health measures and ramped-up policy response. See our full [Midyear outlook](#) for the granular changes to our asset views.

Market backdrop

Measures to contain the virus are gradually being eased in many developed economies. May's data suggested the worst of the contraction may be behind us, but we see a bumpy restart in coming months. We are tracking the interplay of containment measures and mobility changes on activity as economies have started to reopen. The unprecedented policy response has boosted markets, leaving a potential resurgence of infections and policy implementation as key risks. U.S. Congress is headed for a fiscal cliff as jobless benefits, state support and payroll protection measures are expiring soon.

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, June 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 (DX), 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.

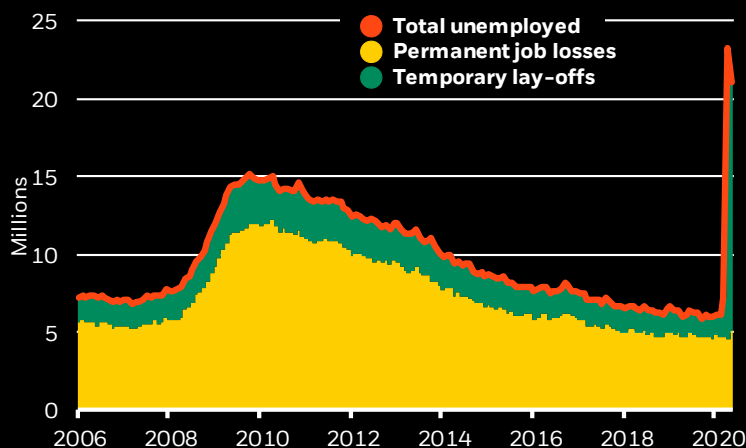
Macro insights

The coronavirus shock could lead to long-term scarring—a permanent reduction of productive economic capacity—via three channels: the labor market, business investment and innovation. Many job losses should be temporary, and capex should recover. But under the hood a major reshuffle of the workforce between sectors is likely necessary. Employment in sectors such as leisure and hospitality may struggle to reach pre-shock levels. Investment has taken a short-term hit, and intangible assets could be lost on the back of insolvencies.

There has been a huge jump in unemployment in the U.S. and use of short-time work programs in Europe. The U.S. picture is reassuring for now, with most unemployment categorized as temporary. See the *Jobless jump* chart. If these job seekers return quickly to work, a rise in long-term unemployment can be avoided. Yet there is already some pickup in permanent layoffs, especially among older workers who are unlikely to re-enter the workforce. Labor market policies may be needed to help retrain workers.

Jobless jump

U.S. unemployment breakdown, 2006–2020



Sources: BlackRock Investment Institute and the U.S. Bureau of Labor Statistics, with data from Haver Analytics, June 2020. Note: The chart shows the total number of unemployed people in the U.S., and the proportion of this number made up of permanent job losers, leavers and new entrants (yellow bars) and temporary layoffs and temporary job completions (green).

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.
- Stringent shutdown measures are gradually being lifted even though the rate of growth in virus cases has picked up in some regions.
- 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 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.
- 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. We could see its balance sheet more than double to just over \$10 trillion by year end to support the fiscal response. The U.S. Treasury set out a \$3 trillion borrowing plan in its quarterly refunding to fund the response.
- We now see a risks of policy exhaustion in the U.S. Next rounds of fiscal stimulus look harder to achieve because of a return of political polarization after a short window of bipartisanship.
- By contrast, we have gained confidence in Europe’s policy response. Combined with additional monetary support, the size of stimulus is broadly sufficient to match the income shortfall on a euro area level, our analysis shows.
- Policy implementation risks remain. It’s crucial to have proper guard rails around policy coordination, as we discuss in [Policy Revolution](#).
- Market implication:** We are underweight nominal government bonds and like inflation-linked bonds on a strategic horizon. Tactically, we like credit as it’s supported by central bank purchases, and see U.S. stocks as 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 raised our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

Week ahead

June 30

U.S. consumer confidence; China official manufacturing purchasing managers' index

July 2

U.S. nonfarm payrolls

July 1

Manufacturing PMI for Japan, China (Caixin), the euro zone and U.S.

July 3

Caixin China services PMI

The U.S. job market data will be in focus. Consensus estimates point toward modest pickup in U.S. employment, yet there is a risk of a sizable decline. Markets will closely watch the U.S. COVID-19 case count trend this week and next, to gauge the development of the outbreak and its implication on the restart process of the economy.

Directional views

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

Asset	Strategic view	Tactical view
Equities	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p> <p>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.</p>
Credit	<div><div></div><div></div><div></div><div></div><div></div></div> <p>+1</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <p>+1</p> <p>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.</p>
Govt bonds	<div><div></div><div></div><div></div><div></div><div></div></div> <p>-1</p>	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p> <p>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.</p>
Cash		<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p> <p>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.</p>
Private markets	<div><div></div><div></div><div></div><div></div><div></div></div> <p>Neutral</p>	<p>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.</p>

Note: Views are from a U.S. dollar perspective, June 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, June 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.
Fixed Income			Momentum
			We keep momentum at neutral. The factor is now dominated by tech stocks on the one hand and defensives on the other, giving investors exposure to growth companies and some potential ballast.
			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.
			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.
Fixed Income			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.
Fixed Income			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.
Fixed Income			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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