Weekly commentary

BlackRock.

Jan. 4, 2021

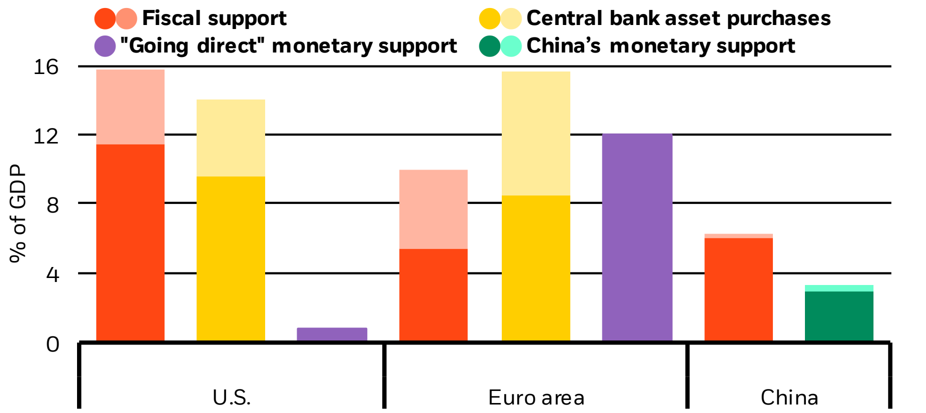
Three investing lessons from 2020

- We share three key lessons we learned from 2020 – and how they inform our 2021 outlook.
- The UK and European Union agreed on a trade deal. The U.S. launched a new $900 billion fiscal package amid climbing Covid hospitalizations and deaths.
- This week's U.S. nonfarm payrolls data is in focus after the labor market appears to have weakened in recent months.

2020 was an extraordinary year for financial markets. The initial Covid shock triggered a massive selloff, followed by a risk rally that extended to the year end. We drew three key lessons from navigating markets. First and foremost, the nature of the Covid shock and the policy revolution triggered by the pandemic were core to the performance of risk assets and our overall asset views.

Chart of the week

Estimated fiscal and monetary support in key economies, 2020 and 2021



Sources: BlackRock Investment Institute, with data from Haver Analytics, December 2020. Notes: The orange bars show estimates of the discretionary fiscal measures in 2020 and 2021 in response to the pandemic, based on proprietary and broker research. The green bars show the estimated impulse of monetary growth in China measured via total social financing. The purple bars show the direct central bank support via programs such as the euro area's Targeted Longer-Term Refinancing Operations. The yellow bars show central bank purchases of sovereign debt. For the U.S. we assume the Federal Reserve purchases an additional $80 billion of U.S. government debt per month through 2021, in line with its recent policy announcement. For the euro area we include purchases under the Pandemic Emergency Purchase Program, and the additional 120 billion-euro purchases announced under the Asset Purchase Program. Bars of darker shades represent 2020, and those of lighter shades 2021.

The initial Covid shock triggered a market plunge in early March. Early in the crisis we assessed the ultimate cumulative economic losses – what matters most for financial markets – would likely prove to be a fraction of those seen in the wake of the 2008 global financial crisis. We saw the Covid shock as more akin to a large-scale natural disaster that would be followed by a swift economic restart – if policy support could provide a bridge. We then witnessed the extraordinary policy response, and saw it as an opportune time to raise our strategic allocation to equities. On a tactical horizon we upgraded credit and increased our preference for quality assets – and held our moderate pro-risk stance over the rest of 2020. We also see the ongoing policy revolution as a major underpinning of our 2021 global outlook. The ongoing fiscal and monetary policy support in 2021 will help prevent economic scarring as Covid vaccines create a bridge to a post-pandemic economy, in our view. See the chart above.

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A key consequence of the policy revolution is the potential for a more muted response of nominal yields to higher inflation, as reflected in *The new nominal* theme in our 2021 outlook. We expect nominal yields to be capped by central banks as they have signaled they will be more willing to let economies run hot with above-target inflation. The result: stronger growth and declining real (inflation-adjusted) yields. We see this combination as under-appreciated by markets, and a potential booster to risk assets even as the prospect of a widespread Covid vaccination campaign has buoyed markets in recent months.

The second lesson from 2020 is the importance of long-term structural trends as drivers of asset performance. For example, the pandemic has reinforced an increased focus on sustainability and the dominance of e-commerce at the expense of traditional retail. Tech exposures with long-term structural tailwinds have continued to outperform. This helps inform our barbell approach to risk assets over the next six to 12 months: quality assets such as tech and healthcare stocks on one end, and selected cyclical exposures on the other. Quality assets with strong balance sheets and cash flows also offer resilience against potential bumps on the road to a full activity restart, in our view. We maintain our overweight in the quality style factor – a view that worked out well throughout 2020. We see traditional “value” sectors facing structural challenges that have been exacerbated by the pandemic, which could limit their upside even with a rapid restart.

The third lesson: It is important to be selective in cyclical exposures. In our midyear 2020 outlook we recognized the importance of tilting back into cyclicality. We closed our overweight in U.S. and Asia ex-Japan equities, and upgraded European equities to overweight. These calls turned out to be less successful than some of our other views, such as overweights in high yield credit and the quality style factor. We’ve since turned neutral on emerging market (EM) debt, and positive on EM equities.

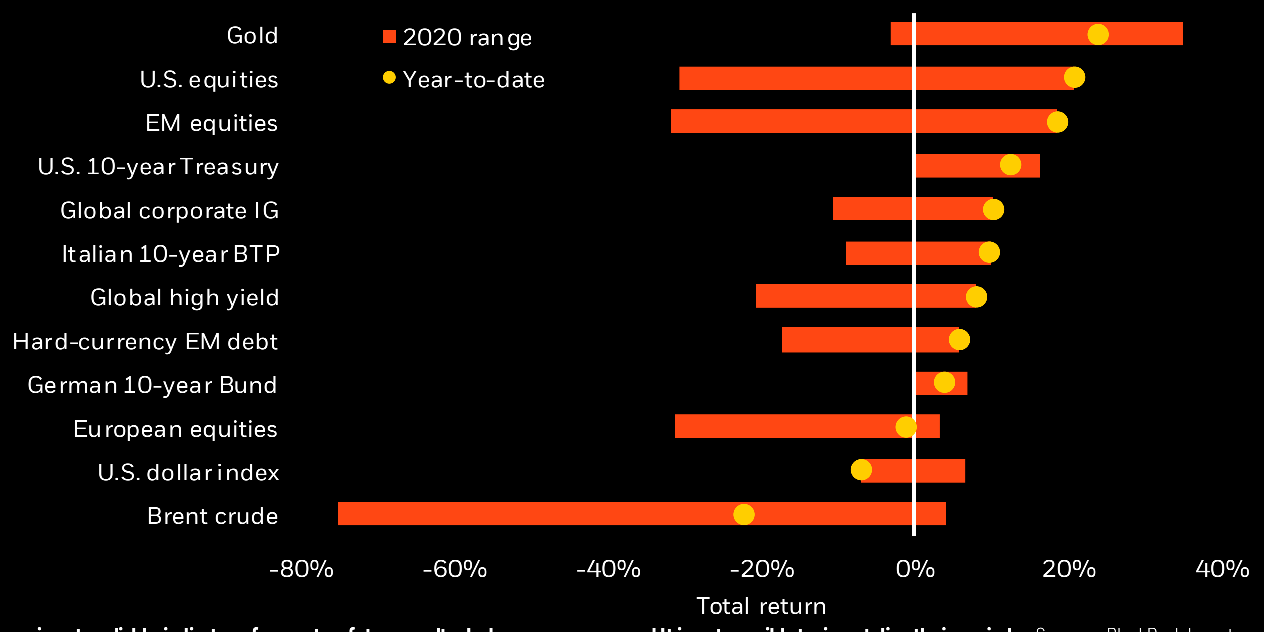
The bottom line: Our directional risk views – driven by the nature of the Covid shock and the policy revolution – were critical in navigating turbulent market conditions last year. A key takeaway is how swiftly macro policies can evolve and the lasting impact this can have on market dynamics. The policy revolution that started in 2020 is still a key driver of our investment views for this year. Read details in our 2021 global outlook.

Market backdrop

U.S. President Donald Trump has signed the new $900 billion fiscal package into law after months of negotiations among lawmakers, as Covid deaths climbed, restrictions tightened and data showed signs that the restart was losing steam. The UK and European Union have agreed on a trade deal. The UK has approved the AstraZeneca/Oxford Covid vaccine as evidence has emerged that a more infectious strain of the coronavirus is spreading. We prefer to look through any near-term volatility and use it to add to high conviction investments.

Assets in review

Selected asset performance, 2020 year-to-date and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, December 2020. 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: spot gold, Datastream 10-year benchmark government bond (U.S., German and Italy), MSCI USA Index, Bank of America Merrill Lynch Global Broad Corporate Index, MSCI Emerging Markets Index, J.P. Morgan EMBI index, Bank of America Merrill Lynch Global High Yield Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index and spot Brent crude.

Macro insights

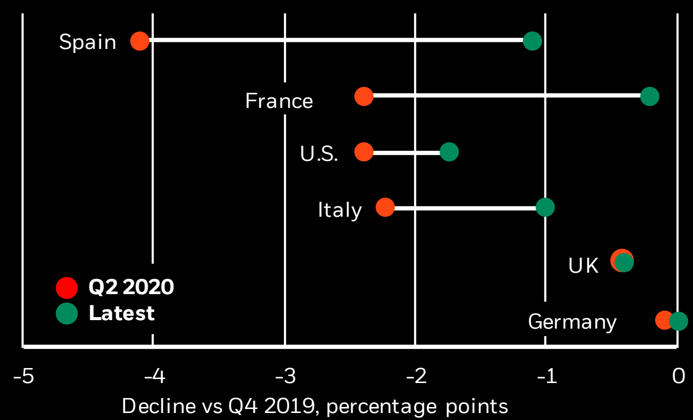
The successful and timely deployment of vaccines will be the key driver of the activity restart in 2021, in our view. Once overall economic activity returns to pre-Covid levels – currently expected by consensus to happen by the end of 2021 – the market focus will likely shift to if and when activity will return to the pre-pandemic trend.

The speed with which activity returns to trend crucially depends on whether there is any substantial scarring of potential growth, in our view. Clarity on vaccines should anchor long-term expectations, limiting the extent of scarring and justifying further policy support.

The pandemic has accelerated sectoral and distributional shifts. For example, contact-intense services sectors that employ a large number of low skilled workers have taken a major hit. An important signpost we will monitor as we track the economic restart: the share of permanent job losses and labor participation rates. See chart on the right for labor participation rates in key economies.

Decline in labor participation

Labor participation, latest vs Q4 2019



Sources: BlackRock Investment Institute, with data from INE, ISTAT, FSO, INSEE, ONS, BLS and Haver, December 2020. Notes: The chart shows the change in labor participation for the respective country. The latest data is as of Q3 2020 for countries except the U.S. The latest U.S. data point is the November Employment Situation report.

Investment themes

1 The new nominal

- We see stronger growth and lower real yields ahead as the vaccine-led restart accelerates and central banks limit the rise of nominal yields – even as inflation expectations climb. Inflation will have different implications to the past.
- The policy revolution as a response to the Covid shock implies that nominal yields will be less responsive to rising inflation risk than in past episodes. This suggests risk assets will perform better than in past inflationary periods.
- Medium-term inflation risks look underappreciated. Production costs are set to rise on a rewiring of global supply chains. Central banks appear more willing to let economies run hot with above-target inflation to make up for past inflation undershoots. They may also face greater political constraints that make it harder to lean against inflation.
- **Market implication**: Strategically we underweight nominal government bonds, favor inflation-linked bonds and see equities supported by falling real rates. Tactically we are pro-risk, preferring U.S. equities and high yield credit.

2 Globalization rewired

- The pandemic has accelerated geopolitical transformations such as a bipolar U.S.-China world order, and a rewiring of global supply chains for greater resilience – with less emphasis on efficiency.
- Strategic U.S.-China rivalry looks here to stay, with competition and bifurcation in the tech sector at its core. We believe investors need exposure to both poles of global growth.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a clear case for greater exposure to China-exposed assets for returns and diversification, in our view.
- We expect persistent inflows to Asian assets as many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels, yuan depreciation and U.S.-China conflicts. But we believe investors are well compensated for these.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like EM equities, especially Asia ex-Japan, and are underweight Europe and Japan.

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 outperformance of a handful of tech giants in recent years. Yet we see tech exposures as having long-term structural tailwinds despite their increased valuations.
- 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.
- **Market implication**: Strategically we prefer sustainable assets amid a growing societal preference for sustainability. Tactically we take a barbell approach, favoring quality stocks balanced with selected cyclical exposures.

Week ahead

Jan. 4	Manufacturing purchasing managers' index (PMI) for Japan, China, the euro area, U.S.	**Jan. 7**	Euro area flash December inflation
Jan. 6	Services PMI for Japan, China, the U.S., France, Germany; euro area composite PMI	**Jan. 8**	U.S. nonfarm payrolls

U.S. December nonfarm payrolls data will be in focus this week. The November report and other job market data in recent weeks have been disappointing, as rising Covid deaths have led to more business restrictions and pointed to near-term risks. We see the positive vaccine news as a game changer as it provides clarity for policymakers, households and businesses about getting to a post-Covid stage.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**Neutral**	**+1**	We are neutral on equities on a strategic horizon given increased valuations and a challenging backdrop for earnings and dividend payouts. We tilt toward EM equities. Tactically, we have upgraded equities to overweight as we expect the restart to re-accelerate and rates to stay low. We like a barbell approach: quality stocks balanced with selected cyclical exposures.
Credit	**Neutral**	**+1**	We are 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 see the economic restart and ongoing policy support helping credit perform, even amid tighter yield spreads and the wind-down of some emergency credit support.
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 policy accommodation suppresses yields.
Cash		**Neutral**	We are neutral and use cash to fund overweights in equities and credit. Holding some cash makes sense, in our view, as a buffer against the risk of 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. 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.

Note: Views are from a U.S. dollar perspective, December 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, December 2020

	Asset	Underweight	Overweight	
Equities	United States			We have upgraded U.S. equities to overweight. 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.
	Euro area			We have downgraded European equities to underweight. The market has relatively high exposure to financials pressured by low rates. It also faces structural growth challenges, even given potential for catch-up growth in a vaccine-led revival.
	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
	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.
	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.
	Momentum			We keep momentum at neutral. The factor could face challenges in the near term as a resurgence in Covid-19 cases and risks of fading fiscal policy support create potential for choppy markets.
	Value			We are neutral on value. 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 that have been exacerbated by the pandemic.
	Minimum volatility			We are underweight min vol. We expect a cyclical upswing over the next six to 12 months, and min vol tends to lag in such an environment.
	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.
	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 is likely to be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries. We see nominal U.S. yields as staying rangebound, but real yields declining amid rising inflation expectations. This leads us to prefer inflation-linked over nominal government bonds.
	Treasury Inflation-Protected Securities			We are overweight TIPS. We see potential for higher inflation expectations to get increasingly priced in on the back of structurally accommodative monetary policy and increasing production costs.
	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.
	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 have downgraded investment grade credit to underweight. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
	Global high yield			We have trimmed our overweight in global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
	Emerging market – hard currency			We have upgraded hard-currency EM debt to neutral. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			We have upgraded local-currency EM debt to neutral. We see catch-up potential as the asset class has lagged the risk asset recovery. Easy global monetary policy and a stable-to-weaker U.S. dollar should also underpin EM.
	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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