Weekly commentary

BlackRock

September 27, 2021

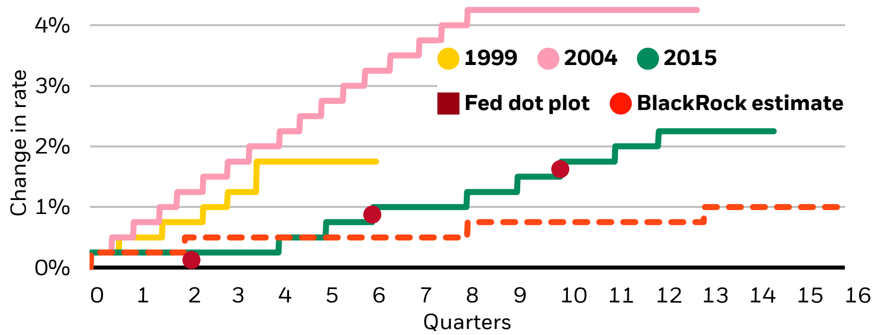
Why we stay pro-risk

- We stay tactically pro-risk amid the broadening economic restart, with negative real rates supporting risk assets – as per our *new nominal* theme.
- The Fed signaled it will start to taper around the year-end. Its reluctance to confirm inflation is meeting its new objective supports our *new nominal* theme.
- U.S. personal income and consumption data will be in focus, while purchasing managers' index data could shed light on the restart amid the delta spread.

Markets have been jittery amid focus on China's regulatory clampdown and the prospect of the Federal Reserve tapering its asset purchases. We believe the path for further gains in risk assets has narrowed after an extended run higher, warranting a selective approach, but we reaffirm our tactical pro-risk stance. In the context of very small client allocations to Chinese assets, we are dipping our toes in the asset class by shifting our view to a modest overweight.

The *new nominal* stands

U.S. policy rate path vs. past cycles



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, Federal Reserve, with data from Refinitiv Datastream , September 2021. Notes: The red dots show the median federal funds rate expectations published by the Federal Open Market Committee, a committee within the Fed that sets the federal funds rate. The lines show past rate hiking cycles since 1999 and our estimates for the path of U.S. interest rates. The paths are shown relative to the point at which the first hike took place, which is indicated by quarter 0. The Fed median dot plot comes from the September 2021 Summary of Economic Projections (SEP). Since the SEP projections show only the end-of-year forecast for the federal funds rate we reflect the uncertainty by showing end-of-year dots rather than a continuous line. We believe the Fed will start its next hiking cycle in the first half of 2023.

The Fed has signalled it is gearing up to start tapering around the end of the year. It appears reluctant to admit its inflation mandate has been met, and this reinforces our *new nominal* theme – or a more muted response to higher inflation from central banks than in the past, a positive for risk assets. See the chart for past rate hike cycles and our estimate. Despite ongoing risks around the fallout from the regulatory clampdown, we are dipping a toe in Chinese equities by moving our tactical view from neutral at midyear to a modest overweight. This call is partly rooted in our expectation for incremental near-term easing via three policy levers – monetary, fiscal and regulatory – with growth slowdown likely having reached a level that policy makers cannot ignore. We see Q4 growth likely dropping to 3% range from Q1's 18%. We believe the significant repricing – Chinese equities underperforming U.S. peers by more than 30 percentage points so far this year - and a rise in equity risk premia in Chinese equities are overdone, especially with a 6-12 month horizon. Investors are compensated for risk at current valuations in our view, but we favor a quality bias.

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BlackRock **Investment** Institute

We believe that the very small index weights and client allocations effectively represent a large structural underweight to the world's second-largest economy and that this could increase significantly before it became a bullish bet on China. Our strategic view already takes into account that China is unmistakably on a path toward greater state involvement with social and political objectives taking primacy over economic ones – leading to greater risks and the need for a new investment lens. But context is everything: Our allocations to Chinese assets remain orders of magnitude lower than those to developed market assets. Currently very small client allocations to Chinese assets would imply a view that China will become essentially un-investable despite its growing importance.

We are also shifting our tactical stance on emerging market (EM) local-currency debt to a modest overweight. We do not see the Fed's tapering leading to an EM tantrum given the higher real yields and improved external balances in EM. EM local-currency debt also offers attractive valuations and coupon income in a world starved for yield. We prefer EM local-currency debt because of its lower duration than EM dollar debt, in line with the significant underweight to U.S. Treasuries, and the steep local yield curves that bring attractive term premium. In addition, we believe much of the early tightening cycle in many EM economies is behind us, and this lends support to EM local-currency debt.

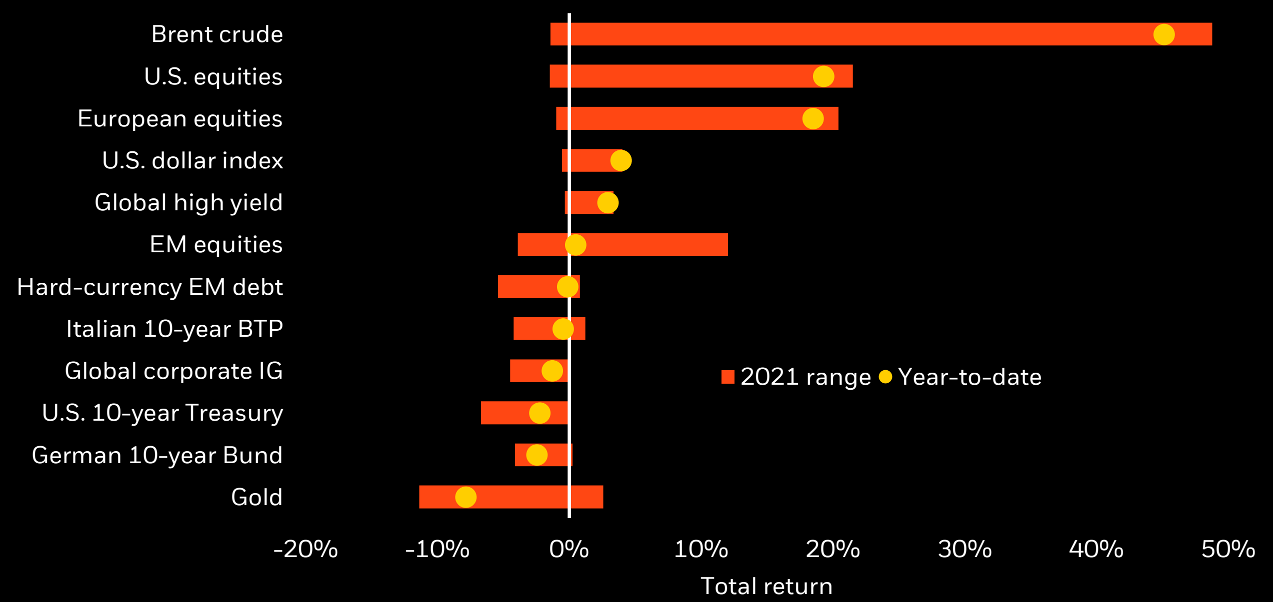
These two modest upgrades don't mean that we have become more pro-risk tactically. In fact we see a narrowing path for risk assets to push higher, and there could be bouts of volatility along the way as markets are prone to over-reaction after an extended bull run in risk assets. Yet over a 6-12 months horizon we still see broadening restart and *the new nominal* supporting risk assets. We stay overweight on European equities as we see the region continuing to benefit from the broadening restart. We are still underweight U.S. Treasuries, as we see only a gradual rise in nominal yields even with the Fed poised to gear up to start tapering by the end of the year. We prefer Treasury Inflation-Protected Securities over nominal bonds for portfolio duration exposure, especially after the recent pullback. We are underweight global investment grade credit as we see little room for further yield compression. Read our detailed views in our Q4 Global outlook update. Implementation of asset views will differ across investor types and geographies, depending on objectives, constraints and regulation.

Market backdrop

The Fed has signaled it will start to taper around the year end. Its reluctance to confirm inflation is meeting its new objective reinforces our *new nominal* theme. Worries about a default by China Evergrande, a debt-laden property developer, triggered a short-lived risk selloff. We see little contagion risk as we believe Chinese authorities will not allow a disorderly property sector deleveraging that would undermine economic and social stability.

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 Sept. 23, 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 USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, J.P. Morgan EMBI Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream U.S. 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index and spot gold.

Macro insights

Fed Chair Jerome Powell last week indicated that a taper announcement could come in early November, and that the taper itself could be complete by mid-2022. Yet he also stressed the higher bar for rate lift-off than for tapering.

It is clear the Fed does not yet see either its inflation or its employment goals as met – a prerequisite for lift-off – despite the fact that the Fed's updated forecasts show inflation above the 2% target for the next three years. Average inflation with a 3-5 year lookback is also now above 2%. See the chart. Still, even though the Fed now forecasts more rate hikes in the future than it did in June, the pace is much slower than the historical average.

This underscores our *new nominal* theme – that central banks are responding in a more muted way to rising inflation than in the past. Further clarification will be needed from the Fed on what it will take to meet its inflation objective under its new flexible average inflation targeting framework – but so far Chair Powell seems keen to use its flexibility to argue a more dovish case. See our macro insights hub.

New nominal still holds

Average inflation over a 3-5 year window, 2005-2021

Sources: BlackRock Investment Institute and Bureau of Economic Analysis, with data from Refinitiv Datastream, September 2021. Note: The chart shows the average annualized month-on-month U.S. core PCE inflation rate over a range of backward-looking windows, from three to five years long.

Investment themes

1 The new nominal

- The powerful restart of economic activity has broadened, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term. We see the Fed normalizing policy rates only in 2023 and the European Central Bank staying pat for much longer.
- *The new nominal* has largely unfolded in 2021: the rise in long-term yields has been mainly driven by higher market pricing of inflation, with real yields remaining pinned well in negative territory.
- The Fed has signalled that it is gearing up to start tapering around the end of the year. It appears reluctant to confirm its inflation mandate has been met, and this reinforces our *new nominal* theme.
- The ECB has made a significant change to its monetary policy framework by adopting a symmetric inflation target of 2%. We believe this is part of a global trend to relax the constraints in earlier frameworks preventing looser policy.
- **Tactical implication**: We are overweight European equities and inflation-linked bonds. We are neutral on U.S. equities. We upgrade EM local-currency debt to modest overweight.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- Chinese authorities have started loosening policies as growth slows, yet we believe they will maintain the broadly hawkish policy stance over the medium term to stay focused on the quality of the growth. The pace and intensity of the regulatory crackdown on some private industries could moderate.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We turn modestly positive on Chinese equities, and maintain an overweight on its debt.
- **Strategic implication:** Given the small benchmark weights and typical client allocation to Chinese assets, allocation would have to increase by multiples before they represent a bullish bet on China, and even more for government bonds.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. The path is unlikely to be a smooth one – and we see this creating opportunities across investment horizons.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- Climate risk is investment risk, and we also see it as a historic investment opportunity. Our long-run return assumptions now reflect the impact of climate change and use sectors as the relevant unit of investment analysis.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

Sept. 28	U.S. consumer confidence
Sept. 30	China official manufacturing purchasing managers' index
Oct. 1	Euro area flash inflation; U.S. ISM manufacturing PMI manufacturing PMI; U.S. personal income and consumer spending, PCE inflation

Market attention this week will be on U.S. consumption and income data, which includes the August PCE inflation rate. Early survey data for September could shed light on the ongoing restart in activity and in particular how much the spread of the delta variant in the U.S. is weighing on activity in the near term.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, September 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	We keep our 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 indices. 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 quality bias.
Credit	**-1**	**Neutral**	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	**-1**	**-1**	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. 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 – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		**Neutral**	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
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 and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, September 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, September 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We stay overweight European equities on the back of a strong growth backdrop. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			We turn modestly positive to upgrade Chinese equities to overweight as we see a gradual dovish shift in monetary and fiscal policy in response to the cyclical slowdown and anticipate that the regulatory clampdown will become less intense.
Equities	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. Potential knock-on effects from slower growth in China and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries primarily on valuations. We see the balance of risks is for gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We are overweight Chinese government bonds. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We remain underweight investment grade credit We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield after the asset class' strong performance. Spreads are now below where we see high yield as attractive valued. We prefer to take risk in equities.
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 upgrade local-currency EM debt to overweight. We believe the asset class offers attractive valuations and carry in a world starved for income.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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