

Weekly commentary

October 25, 2021

BlackRock

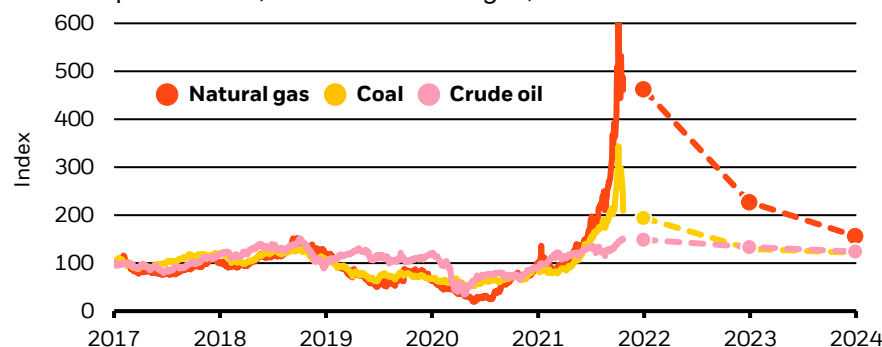
A lopsided energy transition

- The economic restart has laid bare a lopsided transition toward low-carbon energy that has amplified a surge in coal and natural gas prices.
- U.S. stocks rallied to all-time highs on better-than-expected corporate earnings. Oil prices hit multi-year highs.
- Investors will watch activity and inflation data from the U.S., euro area and Germany for clues on the impact of supply chain disruptions on growth.

Surging natural gas and coal prices amid a powerful economic restart have exposed a lopsided transition toward low-carbon power. We still see an orderly transition in the medium term – but with bumps on the way that could lead to growth and inflation volatility. We expect the transition to reinforce a shift to a higher inflation regime, supporting our new nominal theme that points to a more muted central bank response to rising inflation than in the past.

Volatile prices

Futures prices of oil, coal and natural gas, 2017-2024



Sources: BlackRock Investment Institute, with data from Refinitiv, October 2021. Notes: Prices are based to 100 at the start of 2017. We use the European Energy Derivatives Exchange futures, ICE Rotterdam coal futures and Brent crude oil futures to represent natural gas, coal and Brent crude oil respectively. The dots show futures prices for contracts that expire in December 2022, December 2023 and December 2024.

The powerful restart has driven up oil prices to multi-year highs, as we argued in [the previous Global weekly commentary](#). Coal and gas prices have surged far more. See the chart above. Why? On top of the restart, a range of weather and geopolitical factors have restricted supplies of coal and renewable energy. It's been difficult for other sources of power to be brought on stream. This is putting sharp pressure on prices of available sources of power. With governments looking to minimize carbon emissions, gas prices have risen even further than coal. All these events have exposed an underlying issue: The transition to net zero so far has been lopsided, as clean energy investment has not increased enough to make up for the decline in fossil fuel investment. Futures markets are pointing to lower coal and gas prices by the end of next year. Much depends on the temperature in the coming winter. And while the transition remains lopsided, we can expect more volatility of energy prices, inflation and economic activity in future.



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For now governments may find themselves compelled to support greater use of fossil fuels – particularly gas – amid energy supply shortages. Natural gas may emit less carbon than oil or coal, but its largest component methane is another potent greenhouse gas. It too will ultimately need to be phased out if the world is to reach net-zero. The phase-out of natural gas and momentum toward net zero therefore rest on accelerating the development of clean energy supply.

There has been massive investment in clean energy – an average of \$1 trillion a year between 2016 and 2020 according to the International Energy Agency (IEA). More is needed to build a clean, resilient energy infrastructure. A net-zero transition by 2050 will require an average annual investment of nearly \$4 trillion between 2026 and 2030, says the IEA. A successful transition will not only need clean energy, but also new technologies to store and distribute clean energy, to decarbonize manufacturing, agriculture and transport, and to capture carbon emissions.

The pace and precise nature of the net-zero transition will be guided by government policy, which will vary across countries. More clarity on climate policies will help encourage the private sector to invest in clean energy and related technologies. That's why commitments from governments at the upcoming United Nations climate summit (COP26) will be key to watch. The pace of transition around the world will vary by country, and emerging markets are in urgent need of funding for low carbon investment at scale, as we have highlighted in a recent publication [*The big emerging question*](#).

The bottom line: An orderly – albeit lopsided – net-zero transition will have bumps along the way that could lead to greater inflation and growth volatility. We view the net-zero transition as modestly inflationary overall, and via higher inflation contribute to a new nominal environment (see our investment themes). The transition creates investment opportunities in both public and private markets. Over a strategic horizon we like the sectors that stand to benefit more from the transition, whether for being solution providers or by being less exposed to climate risks, such as tech and healthcare. We also see strategic opportunities in the infrastructure space that are related to the development of new technologies that are needed to reach net zero. We prefer inflation-linked bonds over their nominal counterparts over a strategic horizon due to the inflationary pressure.

Market backdrop

U.S. stocks rallied to all-time highs, boosted by better-than-expected corporate earnings. Nearly a quarter of S&P 500 companies have reported earnings so far, and more than 80% of them have beaten expectations, according to Refinitiv. Earnings season reaches a crescendo next week, with 164 companies representing 47% of the S&P 500 market cap due to report earnings, including most of the big-cap tech names. Crude oil prices hit multi-year highs.

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 Oct. 21, 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), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield 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 Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

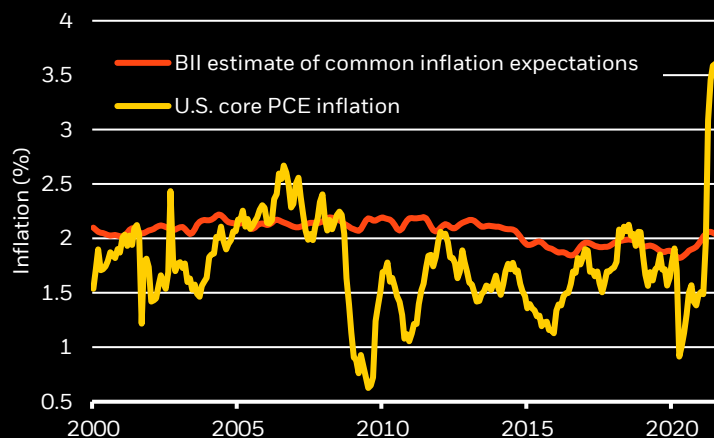
Macro insights

The implication of near-term surging prices for longer-term inflation expectations is a key concern for central banks. If inflation expectations drift higher, it could force their hand to raise rates sooner. Yet tracking inflation expectations is difficult. One way is to combine financial market data and information from surveys of consumers, businesses and professional forecasters into a single index. Comparing such an index against actual inflation outcomes shows that although inflation expectations have risen in the U.S., the scale of change is far smaller than the change in actual core inflation prints. Moreover, inflation expectations remain very close to the Fed's 2% target. See the chart.

One reason for inflation expectations to still be anchored could be personal experience. Many active in the workforce today did not experience the high inflation of the 1970s and 1980s and tend to have lower expectations than those who did. We expect only a limited rise in inflation expectations on the back of the current inflation spurt, allowing the Fed to largely look through the current price pressures. See our [macro insights](#) hub.

Inflation expectations shrug off surge

U.S. core inflation and inflation expectations, 2000–2021



Sources: BlackRock Investment Institute, BEA, with data from Haver Analytics, October 2021. Note: The chart shows U.S. core PCE inflation (yellow line) and our composite measure of U.S. inflation expectations (orange line), which is based on a Federal Reserve research note from September 2020.

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 standing 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

- China is on the path toward greater role of state where social objectives will have primacy over quantity of growth. Yet the growth slowdown has hit levels policymakers can no longer ignore and we expect to see incremental loosening across three pillars – monetary, fiscal and regulatory.
- 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

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today.
- The full consequences of the tectonic shift to sustainability are not yet in market prices, in our view. 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

Oct. 26 U.S. consumer confidence

Oct. 27 U.S. durable goods

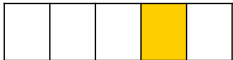

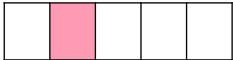

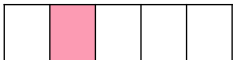
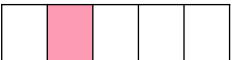


Oct. 28 European Central Bank policy decision; U.S. advance Q3 GDP

Oct. 29 Euro area flash inflation and GDP; U.S. personal income and outlays

Market attention this week will be on the flash estimates of GDP for the U.S., euro area and Germany. We will be looking out to assess the impact from supply disruptions on the growth outlook.

Directional views

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

Asset	Strategic view	Tactical view	Change in view Previous → New
Equities	 +1	 +1	<p>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 cyclical and maintain a quality bias.</p>
Credit	 -1	 Neutral	<p>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.</p>
Govt bonds	 -1	 -1	<p>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.</p>
Cash		 Neutral	<p>We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.</p>
Private markets	 Neutral		<p>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.</p>

Notes: Views are from a U.S. dollar perspective, October 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, October 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.
			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.
			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.
			UK We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European 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.
			China We are 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.
			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.
			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.
			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.
			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.
			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.
			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.
			Global investment grade We are underweight investment grade credit We see little room for further yield spread compression and favor more cyclical exposures such as Asian 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.
			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.
			Emerging market – local currency We are modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and carry in a world starved for 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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