# Weekly commentary

November 29, 2021

BlackRock

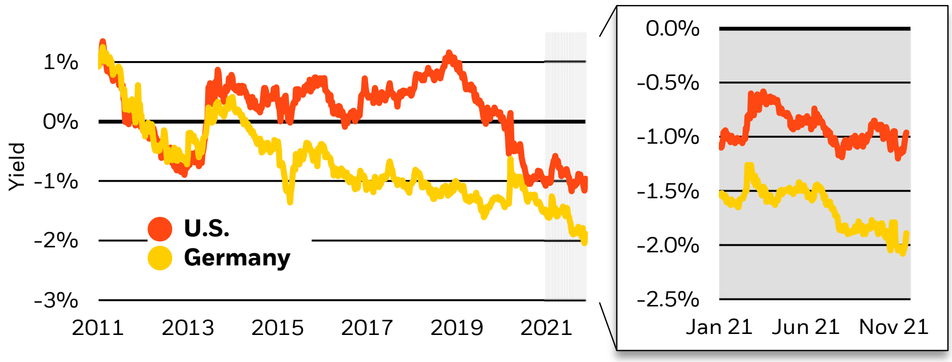
## Staying invested amid new virus strain

- We stay invested for now as a new virus strain and European COVID surge are hurting risk sentiment. Any delay of the powerful restart now means more later.
- News of the contagious new strain triggered a sell-off in risk assets. Jerome Powell was nominated to stay on as Fed chair, heralding continuity in Fed policy.
- U.S. jobs numbers will give investors the latest read on the U.S. labor market, a key focus for the Fed after it already reached its inflation target.

A new, highly contagious, virus strain could trigger growth downgrades, worsen risk sentiment and have significant sectoral impact. We are concerned about the human toll and expect renewed restrictions on activity. We still favor equities for now, but would change our stance if vaccines or treatments were to prove futile. If they are effective, the strain only delays the restart of economic activity, and we would lean against any stock market pullbacks. Less growth now means more later.

### Low rates, for real

U.S. and German 10-year government real bond yields, 2011-2021




Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, November 2021. Notes: charts show the yield on U.S. and German 10-year benchmark inflation-linked government bonds.

News of a contagious new virus strain called Omicron and an ongoing COVID surge in Europe have hurt risk sentiment. We see this affecting services dependent on economic activity, but are less concerned about the broad macro picture for now. Vaccine campaigns so far have proven effective and versatile. It would be a game changer if the new strain were to significantly compromise vaccine effectiveness and question the restart, but there is no evidence of this yet. Government restrictions will be lighter and more targeted than previous lockdowns, we believe, and their effect on economic activity has been waning as the world has adapted. See our COVID-19 tracker for the latest trends. Most importantly, we still see negative real, or inflation-adjusted, yields supporting equities. Real yields had edged up before the virus news but are still hovering near record lows, as the chart shows. The reason is a more muted response to inflation, thanks to fiscal–monetary coordination to bridge the virus shock and central bank policies of letting inflation run a bit hot. We expect real yields to rise from here, but stay at historically low levels in the inflationary environment. This makes equities valuations look better than they otherwise would, and challenges cash and nominal bonds.

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The emergence of Omicron caused government bond yields to fall sharply late last week, but we believe the direction of travel is still up. We see the Fed starting to gradually raise rates in 2022 as the economy no longer requires stimulus - assuming the virus strain does not derail the economic restart. This would push yields higher across the spectrum, keeping the outlook challenging for nominal bonds. We believe equities offer higher risk-adjusted returns and a potential buffer against inflation risks – especially as we see rates rising less than in previous hiking cycles – and less than markets expect.

We recently stress-tested this thesis as risks have risen that policymakers or markets misread the current spike in inflation. Inflation expectations could spiral upward or, conversely, central banks could tighten prematurely. Both scenarios would suggest higher policy rates than our base case, and spell trouble for both stocks and bonds. If the Fed were to react to inflation just like it has done in the past, it would start raising rates much faster and to a higher level than markets currently expect. This would abruptly end the monetary and fiscal policy revolution that has brought about massive debt levels and a higher tolerance for inflation – and turn us neutral on equities on a strategic horizon, as we explain in our latest *Portfolio perspectives* publication for professional investors.

We don't think such a scenario is likely, as it would require the Fed to abandon or completely reinterpret its new policy framework. What really matters for long-term investors is the sum total of growth and rate increases, we believe, rather than the individual parts or timing. This applies to both COVID-related risks that slow the restart and to the Fed's rate trajectory. It's why our core strategic asset views - a broad preference for equities over nominal government bonds and credit - have remained stable through the noisy restart. Importantly, we see government bonds offering less portfolio diversification against equity selloffs than in the past at their historically low yield levels.

The bottom line: Omicron could trigger growth downgrades, worsen risk sentiment and hit services sectors, especially in the near term. It could even question the restart if vaccines or treatments were to prove ineffective. If they are effective, the new strain only delays the restart, and we don't see it changing the otherwise solid picture for equities: a powerful restart and the prospect of continued low real rates. We are leaning against COVID-related stock pullbacks for now as a result.

# Market backdrop

Stocks and bond yields fell on news of the new virus strain late last week. Earlier in the week, yields had risen after Jerome Powell was nominated to a second term as Fed chair and Fed board member Lael Brainard as vice chair. This prompted the market to price out more dovish policy under a Brainard Fed. We expect the Fed's interpretation of its employment objective to determine the timing of the kick-off on rates and their pace. We see inflation dropping from current levels and settling at a level higher than pre-COVID in 2022, as we expect a historically muted policy response to inflation.

## 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 Nov. 25, 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, spot gold, 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 and Refinitiv Datastream U.S. 10-year benchmark government bond index.

## Macro insights

The powerful economic restart has driven U.S. inflation to its highest rate since the early 1990s. Core PCE inflation, the Fed's preferred gauge, now stands at 4.1% year on year.

Under its new framework, the Fed targets *average* inflation of 2% - meaning overshoots are needed to make up for past undershoots. The Fed has not explained over which time horizon it calculates the average inflation rate, but average inflation is now at 2.19% over a five-year look-back window, as shown in the chart. It is even higher on shorter time horizons. The Fed has clearly met its inflation mandate.

Is this not enough to start hiking rates? Not really. The decision also depends on meeting the Fed's less well-defined full employment mandate. As a result, the key question for rates in 2022 is how the Fed will interpret "broad-based and inclusive" maximum employment, particularly as we expect inflation momentum to carry over into next year.

See our macro insights hub.

## Fed meets inflation mandate

Average inflation with a five-year lookback, 2005-2021


Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, November 2021. Note: The chart shows the average annualized month-on-month U.S. core PCE inflation rate over a backward-looking window of five years.

# Investment themes

### 1 The new nominal

- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve next year. We see inflation as persistent into 2022, moderating from today's elevated levels to settle at higher levels than before COVID.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation. Other developed market central banks have signaled policy rate paths with steeper initial increases.
- We have moved forward our expectation for the Fed to start raising interest rates to next year – if not as soon as the market pricing. But what really matters is the policy rate trajectory, not just the first hike. We expect the most muted policy response to inflation in decades.
- The Fed started tapering bond purchases in November, trimming them by $15 billion a month. The central bank may have achieved its new inflation goal to make up for past misses, but will likely still keep rates low to achieve its more ambitious full employment mandate.
- **Tactical implication**: We prefer equities and inflation-linked bonds, and are underweight U.S. Treasury bonds.
- **Strategic implication**: We are underweight DM government bonds and prefer equities over credit.

### 2 China stands out

- China has emphasized social objectives and quality growth over the quantity of growth in a series of regulatory crackdowns that have spooked some investors. Yet a 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 the ongoing U.S.-China strategic competition, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We are modestly positive on Chinese equities and are overweight government bonds.
- **Strategic implication:** We believe global investors should raise their allocations to Chinese assets for potential returns and diversification, given the small benchmark weights and typical client allocation to Chinese assets. Allocations would need to increase significantly before they reflect a bullish view, in our opinion.

### 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 net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs, yet the economic outlook is unambiguously brighter than a scenario of no climate action.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions. Policy remains the main tool. Some carbon-heavy companies already are changing their business models, independent of regulatory and political outcomes, creating potential investment opportunities.
- We see sustainability-driven repricing as having just begun – with accelerating flows into ESG products a big driver.
- Commodities such as copper and lithium will likely see increased demand from the drive to net zero. It's important to distinguish between near-term drivers of commodities prices – the economic restart – and the long-term transition.
- **Tactical implication**: We see opportunities in companies rapidly adapting their business models for net zero.
- **Strategic implication**: We like DM equities and the tech sector as beneficiaries of the climate transition.

# Week ahead

| | |
|---|---|
| **Nov. 30** | China manufacturing PMI, euro area HICP flash, U.S. consumer confidence |
| **Dec. 1** | U.S. ISM manufacturing PMI |
| **Dec. 3** | U.S. unemployment rate and non-farm payrolls |

U.S. payroll and unemployment data will be in focus this week, given the labor market's relevance for the Fed's rate decisions going forward. The Fed's inflation target has been met, so now the key is how the Fed will interpret the other side of its mandate – full employment. The timing and trajectory of rate increases will depends on this. We see the Fed raising rates only in the middle of 2022 and expect a shallower rate path than in the past as part of a more muted response to inflation.

# Directional views

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

**Change in view**: Previous → New

| Asset | Strategic view | Tactical view | |
|---|---|---|---|
| **Equities** | +1 | +1 | We are overweight equities on a strategic horizon amid fair valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we are overweight equities amid solid economic growth and historically low real rates. |
| **Credit** | -1 | Neutral | We are underweight credit on a strategic basis. 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. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. Tactically, we are also underweight government bonds on expectations of gradually rising yields. |
| **Cash** | | Neutral | We keep some cash to potentially 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, November 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, November 2021

| | Asset | Underweight | Overweight | |
|---|---|---|---|---|
| Equities | United States | | | We are neutral U.S. equities. We see U.S. growth momentum peaking and see other regions as more attractive to capitalize on the next leg of the restart of economic activity. |
| Equities | U.S. small caps | | | We are 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. |
| Equities | Europe | | | We are overweight European equities amid a sizeable pickup in economic activity. Valuations look attractive, and investor inflows into the region are 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. |
| Equities | China | | | We are modestly positive on Chinese equities as we see a gradual dovish policy shift to fend off a slowdown. We expect the regulatory clampdown to last but lessen in intensity. |
| Equities | Emerging markets | | | We are neutral EM equities. Many EM central banks have raised rates in the face of inflation, dampening growth and tightening financial conditions. |
| 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. Risks are tilted toward gradually higher yields as markets price in the economic restart. |
| Fixed Income | Treasury Inflation-Protected Securities | | | We are overweight U.S. TIPS amid high inflation in the near term. TIPS look attractive versus European inflation breakevens as the outlook for euro area inflation remains sluggish. |
| Fixed Income | German bunds | | | We are neutral on bunds. We see little room for a substantive change in monetary policy in the near term. |
| Fixed Income | Euro area peripherals | | | We are neutral euro area peripheral government bonds 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 are underweight investment grade credit. We see little room for further yield spread compression. |
| Fixed Income | Global high yield | | | We are neutral high yield. High yield spreads no longer provide attractive value. 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 are modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and coupon income in a world starved for yield. |
| Fixed Income | Asia fixed income | | | We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield given the region's fundamental outlook. |

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