

Weekly commentary

July 20, 2020

BlackRock

Favoring Euro stocks in global restart

- We consider European stocks the most attractive regional exposure to a multi-speed global restart, especially versus emerging markets outside of north Asia.
- We could see a \$1-1.5 trillion U.S. fiscal package that extends some, but not all, federal stimulus measures through late this year as lawmakers face a fiscal cliff.
- Estimates of Purchasing Managers' Indexes (PMIs) in the U.S., Europe and Japan this week will offer investors an early peek at business sentiment.

As economies start to normalize, we see European equities as the most attractive regional exposure to a differentiated global reopening. The region sports a robust health infrastructure, exposure to a pickup in global growth, and galvanized policy response with room for more stimulus. As a result, we see it offering better risk-reward than traditional beneficiaries of a growth pickup: emerging markets (EMs).



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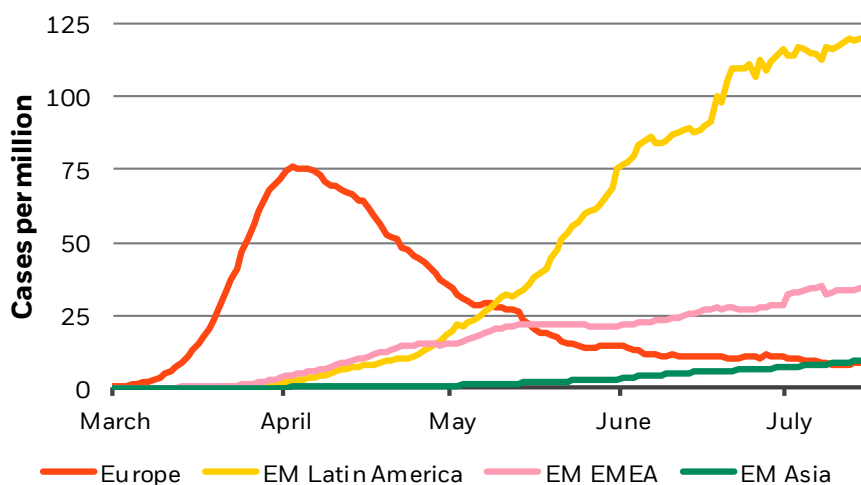
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Chart of the week

New Covid-19 cases as share of population, March–July 2020



Source: BlackRock Investment Institute, with data from European Centre for Disease Prevention and Control. Notes: The chart shows the 7-day rolling average of new confirmed cases as a share of population. Regional aggregates are based on countries within the MSCI Europe, Emerging and Frontier Market indexes.

The pace of the activity restart depends on how successful countries are in suppressing the virus as they reopen, as we detail in our [Midyear Outlook](#). This gives Europe a leg up versus much of the emerging world. Many EM countries have less robust public health systems, and the pandemic has not yet peaked. Infections have jumped in Latin America after an initial lag, as the chart shows, and are steadily rising in emerging Europe, Middle East and Africa (EMEA), and South Asia. By contrast, infections in developed Europe have been on a downward trajectory since peaking in April.

To be sure, EMs are heterogenous. The virus outbreak—and ability to withstand it—varies greatly by country. Many north Asian economies, for example, appear to have gained control of the epidemic – and have relatively strong balance sheets and the policy space to weather the downturn.

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Europe’s health capabilities and containment measures position the region well for a domestic recovery. European companies also are highly geared to an improvement in global trade and a recovering Chinese economy. Some EM economies are likely to benefit, too, and tech-focused Asian countries are showing early signs of a pickup in trade. Escalating U.S.-China trade tensions are a risk to market sentiment toward EM, European and Japanese equities alike in that respect. Europe, however, is less vulnerable to any renewed downturn in commodity prices than EM economies that are heavily exposed to commodities and natural resources, such as Russia and Brazil.

Importantly, the monetary and fiscal support to cushion the virus shock is stronger in Europe than in EM countries and Japan - and there is space and appetite for additional stimulus. After an initially slow start, the euro area has galvanized its policy response. The European Central Bank has made clear that it stands ready to add more monetary stimulus. Leaders of the 27 EU member states last week discussed a groundbreaking, joint economic recovery package at their first physical summit since the start of the coronavirus lockdown. Importantly, unprecedented coordination between fiscal and monetary authorities is allowing the region to unleash stimulus and bring down peripheral borrowing costs at the same time. By contrast, we see the policy space in many EM countries as much more limited, as many risk spiking interest rates and sliding currencies in response to more fiscal or monetary stimulus.

What are the risks in preferring Europe over EM? First, a surprise in the pandemic’s trajectory. This could range from a drop in EM infection rates to a virus resurgence in Europe. Second, EM equities could further outperform European peers if the U.S. dollar weakens against EM currencies or if the global growth upswing is much larger than we expect.

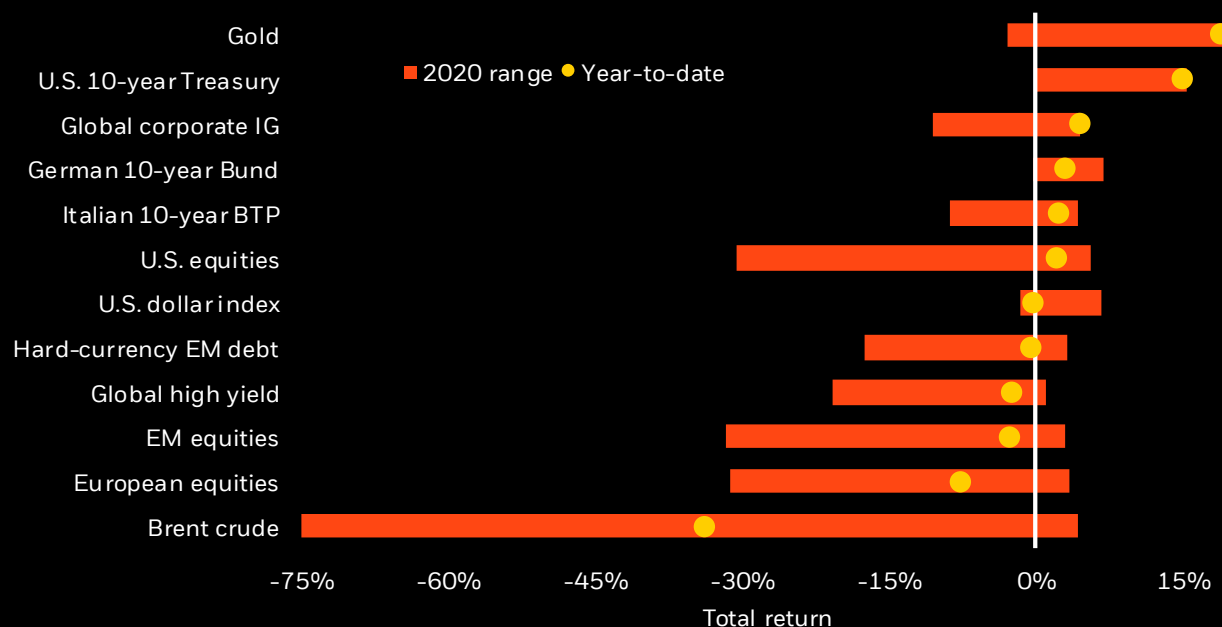
Bottom line: We are overweight European stocks due to the region’s strong public health systems and ramped-up policy response. We are underweight EM equities outside North Asia due to the pandemic’s spread and limited policy space. North Asia has the virus under control for now and has the capacity for more stimulus, keeping us neutral on both Japanese and Asia ex-Japan equities. We like U.S. equities for their quality bias, but the risk of fading fiscal stimulus and election uncertainty keep us neutral.

Market backdrop

Measures to contain the virus are being gradually eased in many developed economies, and lifted activity and employment in June. The unprecedented policy response has boosted risk assets, leaving the U.S. resurgence of infections in Sunbelt states and the possibility of fading fiscal stimulus as key market risks. U.S. Congress is headed for a fiscal cliff as additional jobless benefits and small business support are set to expire, and states face huge budget shortfalls. We could see a \$1-1.5 trillion fiscal package that extends some (but not all) federal stimulus measures through late-2020.

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, July 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 (DXY), 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.

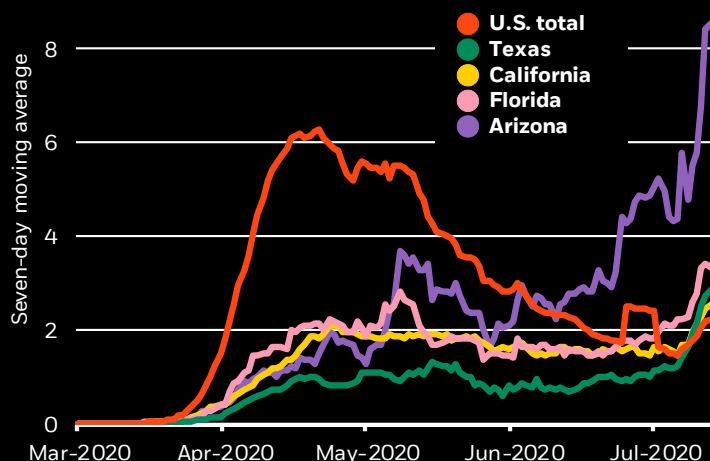
Macro insights

Covid-19 deaths in the U.S. have started to tick up again, driven by several Sunbelt states where new fatalities have surpassed prior peaks. This suggests the restart could be interrupted. Large state economies such as California, Texas and Florida have introduced new distancing measures or rolled back the easing of earlier restrictions.

Importantly, consumers can also change their behaviors voluntarily, something we have found has a greater impact on activity than government measures. A pick-up in various high-frequency data has either decelerated or stalled – often in the absence of new government restrictions. This includes consumer spending in restaurants, clothing and department stores; airline ticket sales; and hotel bookings. These trends are also reflected in Google mobility figures, which appear to be trending downwards since the beginning of July. And Apple driving mobility data have leveled off in states with rising hospitalizations. The key question for markets will be how this affects economic activity in months to come.

Human toll

U.S. Covid-19 fatalities per million, March-July 2020



Sources: BlackRock Investment Institute and The COVID Tracking Project. Notes: The chart shows new deaths from Covid-19 per million people in the U.S. and certain states, as a seven day moving average.

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.
- Shutdown measures are gradually being lifted in areas where infection rates have slowed, such as in North Asia and Europe. A surge in infections in U.S. Southern and Western states has partly reversed reopening measures there.
- 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 equity 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. It's crucial to have proper guard rails around policy coordination, as we discuss in [Policy Revolution](#).
- 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.
- After a slow start, Europe has followed suit, with the European Central Bank's new and more flexible quantitative easing as well as a proposed 750-billion-euro European recovery plan in addition to national stimulus measures.
- The combined sum of fiscal and monetary actions is covering the virus hit to the economy in both the U.S. and euro area, our analysis shows.
- We see a risk of policy exhaustion, especially in the U.S. Additional unemployment benefits and small business support are set to expire, and states may be forced into austerity to close large budget shortfalls. We could see a \$1-1.5 trillion fiscal package that extends some (but not all) federal stimulus measures through late-2020.
- EU leaders appear committed to the recovery plan, but it may take time to implement.
- **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 increased our overweight in the quality factor on a tactical horizon, and favor assets with policy backstops.

Week ahead

July 19 Japan trade data

July 23 Euro area flash consumer confidence





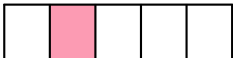



July 22 Japan flash PMI

July 24 Flash PMIs for U.S., euro area and UK

A slew of early estimates of Purchasing Managers' Indexes (PMIs) will be in focus to gauge business sentiment as economies show signs of rebounding. Activity normalization may take time, and the key will be restarting economies without restarting a virus outbreak. We track the interplay between virus outbreaks and mobility changes as a signpost for the pace of activity restarts around the world, as detailed in our [Midyear Outlook](#).

Directional views

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

Asset	Strategic view	Tactical view
Equities	 <p>Neutral</p>	 <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	 <p>+1</p>	 <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	 <p>-1</p>	 <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		 <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	 <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, July 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, July 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.
	Momentum			We keep momentum at neutral. The sectoral composition of the factor provides exposure to both growth (tech) and defensive stocks (pharma). Yet momentum's high concentration poses risks as recovery takes hold.
	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		●	→
Fixed Income	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.
	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.
	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.
	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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