Weekly commentary

April 6, 2020

BlackRock

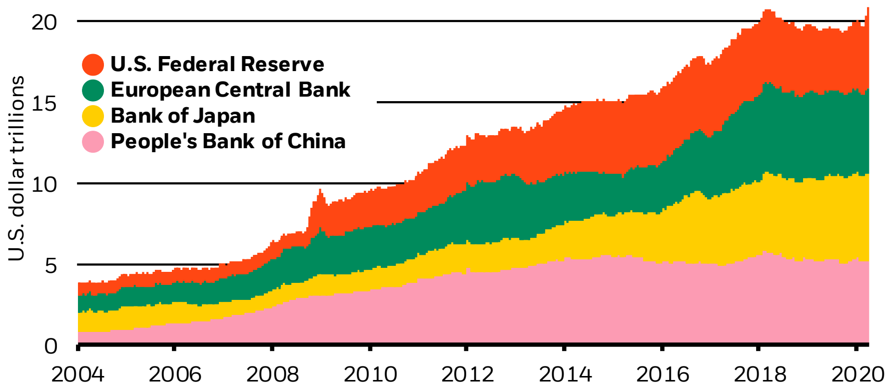
Upgrading credit

- We upgrade our tactical views on credit on extraordinary central bank support and substantially more attractive valuations.
- The initial market rally from historic U.S. policy actions has stalled as worsening economic data and a rising human toll dominate sentiment.
- Jobless claims and consumer sentiment data this week are likely to show more signs of economic damage caused by the coronavirus.

Unprecedented policy actions to limit the coronavirus shock and sharply lower valuations have improved the outlook for credit, in our view. Major central banks are committed to keep rates low and greatly expand their balance sheets. This underpins demand for corporate bonds and selected sovereign credit. We upgrade our view on global investment grade credit to a moderate overweight from underweight and keep high yield as an overweight.

Chart of the week

Central bank balance sheet in U.S. dollars, 2004-2020



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The chart shows the size of the balance sheet of each central bank.

Global central banks have focused on alleviating the dysfunction of market pricing and tightening of financial conditions. The European Central Bank (ECB) has lifted the 750 billion euro cap on its Pandemic Emergency Purchase Program (PEPP), paving the way for potentially unlimited asset purchases. The Fed has adopted a "whatever-it-takes" approach, including a commitment to massively expand its $4.5 trillion balance sheet, lending programs to directly support small- and medium-sized businesses, states and municipalities, and buying U.S. corporate bonds for the first time. Central bank balance sheets in key economies have reached $20 trillion, as the chart above shows, and are poised to increase a lot further. We see coupon income as attractive amid record-low interest rates, a stabilization of markets thanks to the policy response and improved valuations after the March selloff. We find this source of income in global investment grade and high yield credit, as well as euro area peripheral government bonds and local-currency emerging market debt.

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Overwhelming action by fiscal and monetary authorities helps reduce downside risks to the economy – and the risk of an oversized spike in credit downgrades and debt defaults, in our view. The risk of temporary liquidity crunches remains as the economic shutdown rolls on, and sectors such as energy face severe challenges due to the collapse in oil prices. Yet overall, we believe the recent sharp widening in credit spreads means investors are to a large extent compensated for taking on these risks. We prefer credit over equities given bondholders' preferential claim on corporate cash flows in a highly uncertain economic environment.

The history of credit performance during past periods of quantitative easing also supports our view. When central banks step in with massive asset purchases, it tends to dampen volatility in interest rates. We believe we are in a similar situation today: The Fed has effectively committed to cap the upside in long-term bond yields, while expansionary fiscal policy may put upward pressure on interest rates. A relatively stable rate environment has often led to the narrowing of the spread between yields of credit and government bonds – and a rise in prices of credit. It also helps to have central banks as committed buyers of bonds including corporate and sovereign debt.

We have upgraded our tactical view on U.S. Treasuries as an offset to the risks of an increased credit allocation. Yields sit near record lows, but Treasuries are still the highest yielding government bonds in major developed economies. This leaves more room for further yield declines than bonds in the euro area or Japan in the event of risk asset selloffs, in our view. On a longer-term horizon, we recognize the role of government bonds as portfolio ballast has come into question given the lower yield levels and a growing commitment of central banks to keep rates low across the yield curve.

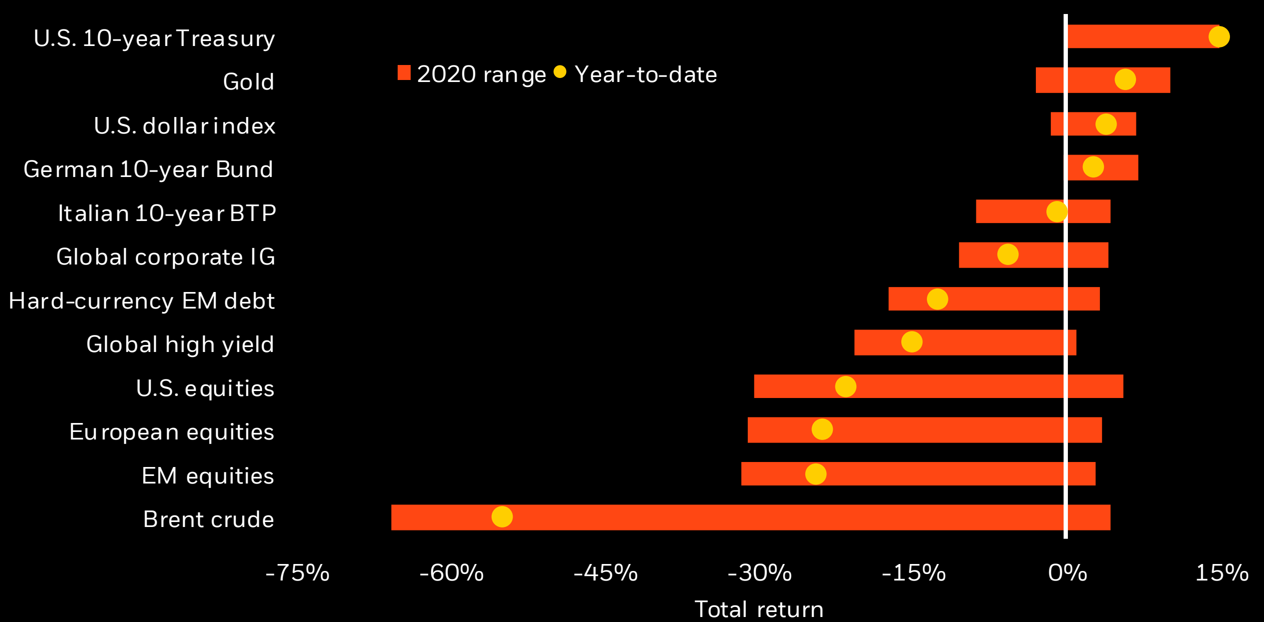
The bottom line: We see coupon income as crucial in an even more yield-starved world. The extraordinary monetary and fiscal policy action is shaping up to blunt the coronavirus shock to the economy and markets – and central banks have stepped back in as committed buyers of credit. This, coupled with substantially cheaper valuations, paves the way for outperformance in carry assets such as corporate debt and euro area peripheral sovereigns, in our view.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus is starting to take shape as the outbreak and related containment measures propagate across the globe. The initial boost to markets from the historic U.S. policy actions has faded as sobering economic data and a rising human toll have dominated sentiment. We still believe the strong policy actions are paving the road for an eventual – and strong – economic and market rebound, once we better understand the scale of the outbreak.

Assets in review

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



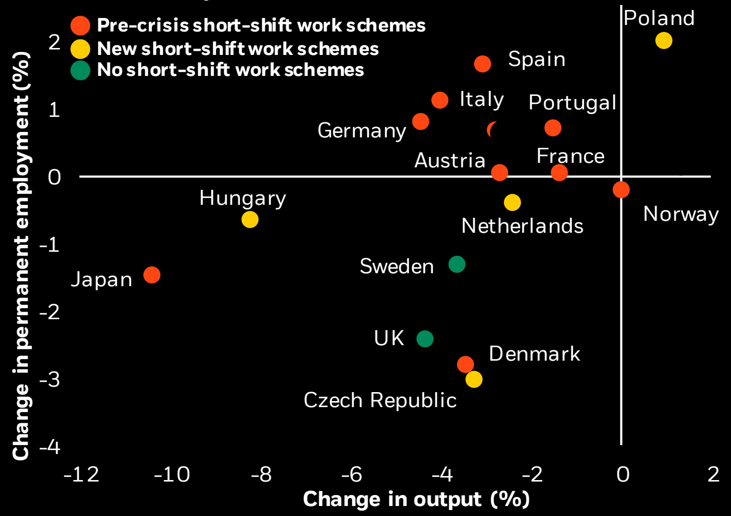
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of 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

Labor market resilience will be key to how quickly economies bounce back from the coronavirus shock. Early indications point to a surge in the number of unemployed – but short-shift work programs similar to those during the global financial crisis (GFC) could limit job losses. In the GFC, countries with existing or new short-shift policies fared better than those without in terms of change in permanent employment. The short-shift policies enabled firms to adjust by reducing their workers' average hours by much more than in other economies. This provides context to the fiscal packages that we have seen proposed over the past few weeks. The German short-shift scheme is expected to attract 2.5 million new participants, versus a peak of 1.5 million during the GFC. The UK has offered to guarantee up to 80% of wages for employees in affected sectors, subject to a monthly cap. In the U.S., the coronavirus stimulus bill includes capacity for work sharing and a program that turns loans into grants for small firms retaining payroll.

The short shift effect

Permanent employment vs output in OECD, 2008 to 2009



Sources: BlackRock Investment Institute, with data from the OECD, April 2020. Notes: The change in permanent employment and output for OECD countries between Q3 2008 and Q3 2009.

Investment themes

1 Activity standstill

- Public health measures to combat the coronavirus outbreak are bringing economic activity to a near standstill and look set to cause a sharp contraction in economic growth in the second quarter.
- The coronavirus shock is unprecedented and much sharper than what we saw in 2008 - but its cumulative hit to growth is likely to be much less than total economic impact of the financial crisis as long as authorities deliver an overwhelming fiscal and monetary policy response to bridge businesses and households through the shock.
- The U.S. will likely prove more resilient than many other developed economies because of a smaller share of manufacturing in its GDP, a relatively high share of healthcare spending and an aggressive policy response.
- We expect a recovery in activity once disruptions dissipate, but their depth and duration are highly uncertain. This could weigh on consumption and investment.
- The main risk to our view: a broadening of the outbreak is not met with a decisive policy response, causing lasting damage to the economy.
- **Market implication**: We are mostly sticking to benchmark holdings on an asset class level and favor rebalancing into the risk asset decline.

2 Bold policy action

- U.S. policymakers have announced a fiscal package of more than $2 trillion and the Federal Reserve has launched extraordinary measures to cushion the economic and market impact. The fiscal package exceeds that of the global financial crisis and includes measures we had advocated: "going direct", or relieving the cash flow pressures facing households and businesses with direct cash payments Read our bulletin on the historic policy response.
- Fiscal policy is on the frontlines and should focus on boosting public health measures and alleviating potential cash flow crunches through liquidity bridges. The U.S response follows coordinated fiscal and monetary action in Australia, Canada and the UK, and a patchwork of fiscal relief supported by monetary policy in the euro area.
- The critical focus of central banks is alleviating the dysfunction of market pricing and tightening of financial conditions. Besides the Fed, The European Central Bank put together a bold response after its communication mishap earlier, lifted the 750 billion euro limit on the pandemic emergency bond buying program. European officials may also activate the European Stability Mechanism on relaxed terms to free up even more bond-buying capacity.
- **Market implication**: Coupon income is crucial in an even more yield-starved world, including corporate credit and dividend income in selected equity sectors.

3 Resilience rules

- The valuations of developed government bonds look stretched in light of our economic outlook, but we still see them providing diversification – albeit less so with some yields near levels we consider to be their lower bounds. The recent bounce in Treasury yields off record lows illustrates the risk of snapbacks.
- A focus on sustainability can help make portfolios more resilient. We believe the adoption of sustainable investing is a new phenomenon that will carry a return advantage over years and decades.
- **Market implication**: We prefer U.S. Treasuries to lower-yielding peers as portfolio ballast and see a strong case for integrating sustainability into investment processes.

Week ahead

Apr. 6–7	German industrial orders and output	**Apr. 9**	University of Michigan Surveys of Consumers
Apr. 8	Japan machinery orders	**Apr. 10**	China inflation

Markets will try to gauge the pandemic's disruption to the economy. The University of Michigan survey will indicate the short-term impact of the outbreak on U.S. consumers – a key pillar of the U.S. economy – after weekly jobless claims hit record highs and private payrolls contracted for the first time since 2017. February factory activity data from Germany and Japan should shed light on the impact from China's lockdown on other parts of the global manufacturing supply chain.

Directional views

Six to 12-month tactical views on major global assets from a U.S. dollar perspective, April 2020

Asset	Underweight	Neutral	Overweight

Equities

We previously downgraded global equities to neutral. The coronavirus outbreak is disrupting economic activity and supply chains. The outbreak also poses risks to corporate earnings, in our view. Accommodative monetary policy is a support. We now favor rebalancing back toward benchmark weights as markets fall.

Credit

We have upgraded credit to modestly overweight. Extraordinary measures by central banks – including purchases of corporate debt – provide a favorable backdrop. Developed market central bank actions should pave the way for lower volatility in interest rates, providing a stable environment for credit spreads to narrow. The risk of temporary liquidity crunches remains. Yet valuations have cheapened and coupon income is crucial in a world starved for yield.

Government bonds

We stay neutral overall on global government bonds. They act as ballast against risk-off episodes. Additional easing by major central banks has become more likely, in our view. We favor U.S. Treasuries over government bonds in other regions, but see risks of a diminishing buffer against equity market selloffs and a snap-back in yields from historically low levels.

Cash

We maintain our neutral position on cash for risk mitigation. We also see cash as a robust buffer against risks around regime shifts, especially those triggered by a negative supply shock that could drive both stocks and bonds lower together.

Note: This material represents an assessment of the market environment at a specific time and is not intended to be a forecast or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, 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, April 2020

	Asset	Underweight	Overweight	
Equities	United States		■	We are overweight U.S. equities for their relative quality bias and the sizable policy response to the outbreak: large fiscal stimulus coupled with the Federal Reserve's commitment to keep rates low and markets functioning.
Equities	Euro area	■		We stay underweight on European equities. We see greater upside elsewhere in an eventual recovery. Europe is more dependent on foreign trade.
Equities	Japan	■		We are underweight Japanese equities. The country has limited monetary and fiscal policy space to offset the outbreak's impact.
Equities	Emerging markets			We are neutral on EM equities. Valuations have cheapened, but the global economic slowdown and cheaper oil challenge many EM economies. The outbreak also is a big test for weak public health systems.
Equities	Asia ex-Japan		■	We are overweight Asia ex-Japan equities on prospects of an eventual growth uptick. We see China as in the early stages of restarting its economy and having more policy space to revive activity.
Equities	Momentum			We are neutral on momentum. The factor has outperformed in the growth slowdown, partly due to its exposure to "secular growers" in the tech industry as well as dividend paying bond proxies.
Equities	Value	■		We remain underweight value. Value has historically performed best in periods of accelerating growth, and we now see the coronavirus outbreak posing downside risks to the economy.
Equities	Minimum volatility		■	We like min-vol for its defensive properties in a growth slowdown. The factor has historically performed well late in the cycle.
Equities	Quality		■	We hold quality as an overweight. We like that it has been resilient in late-cycle periods, despite relatively high valuations.
Fixed Income	U.S. Treasuries		●→ ■	We have upgraded U.S. Treasuries to overweight. Low rates reduce their ability to cushion against risk asset selloffs, but we see greater room for long-term yields to fall further in the U.S. than in other developed markets.
Fixed Income	Treasury Inflation-Protected Securities			We are neutral on TIPS. After a huge decline in rates that makes the entry point less attractive. We still see potential for higher inflation over time and like TIPS in strategic allocations.
Fixed Income	German bunds	■		We remain underweight bunds. They provide little cushion against major risk events, but would not add to our underweight after recent underperformance versus U.S. Treasuries.
Fixed Income	Euro area peripherals		●→ ■	We have upgraded euro area peripheral government bonds to overweight. Renewed asset purchases by the European Central Bank are a major support, and valuations have cheapened.
Fixed Income	Global investment grade	●	→ ■	We have upgraded global investment grade credit. Renewed asset purchases by central banks as well as the prospect of a stable rates backdrop support the sector at a time when valuations have cheapened.
Fixed Income	Global high yield		■	We stay overweight high yield as a source of income, despite recent underperformance. We avoid energy as a lower-for-longer oil price challenges the ability of issuers to refinance near-term maturities.
Fixed Income	Emerging market – hard currency			We stay neutral on hard-currency EM debt due to the heavy exposure to energy exporters and limited policy space among some EMs. We prefer to take our risk in local currency EM debt. Default risks may be underpriced.
Fixed Income	Emerging market – local currency		■	We remain overweight, despite recent underperformance driven by a stronger U.S. dollar. Yields above 5% look attractive – and currency depreciation appears excessive in many markets.
Fixed Income	Asia fixed income		■	We stay overweight based on a slowdown in the spread of the virus, Chinese monetary easing, low energy exposure and reasonable relative value. We see demand from Chinese and regional investors.

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