Weekly commentary

BlackRock

April 13, 2020

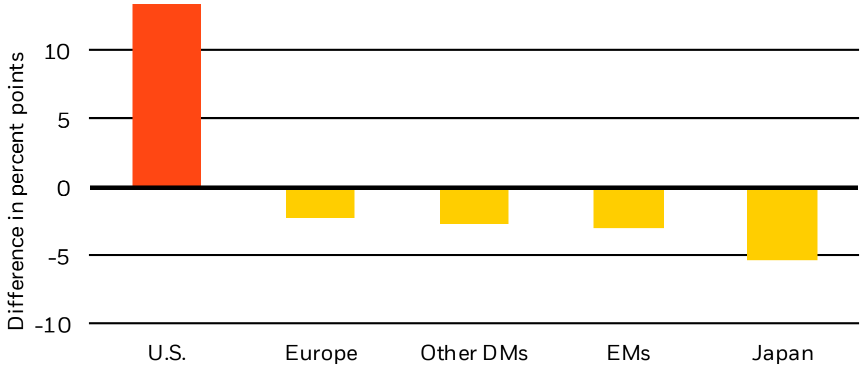
Why we are overweight U.S. stocks

- We highlight our ongoing preference for U.S. equities – based on overwhelming U.S. policy actions and the market's relative quality bias.
- U.S. stocks rallied last week amid tentative signs of a slowing pace in the virus' spread in the U.S. and additional Federal Reserve stimulus.
- This week's U.S. retail sales and industrial production data could start showing the magnitude of the freeze of economic activity.

We see U.S. stocks outperforming their developed market (DM) peers over the next six to 12 months. The overall U.S. policy response to the coronavirus shock has been decisive and comprehensive, already exceeding the scale of policy action in other major developed economies. We expect there is more to come. The U.S. stock market also has a relatively high concentration of quality companies with the capacity to weather the storm, in our view.

Chart of the week

Relative weight in global quality index by country/region, 2020



Sources: BlackRock Investment Institute with data from MSCI as of April 7, 2020. Notes: The bars show the weights of the regional markets in the MSCI ACWI Quality Index minus those on the MSCI ACWI Index.

We see the quality tilt of U.S. stocks as supportive in today's uncertain economic environment. This is reflected in the upsized weight of U.S. companies in the MSCI ACWI Quality Index. U.S. stocks account for more than 70% of the index, nearly 14 percentage points higher than the weight they occupy in the parent MSCI ACWI Index. Other DMs and emerging markets are underrepresented in the quality index, as the chart above shows. The sector composition of the U.S. market may partially explain the quality bias. Information technology is the biggest sector on the MSCI USA Index, making up more than a quarter of its market value. The communication services sector – which includes top Internet and social media companies – takes up 11%. Health care, which tends to have a high return on equity, stable earnings growth and low leverage, makes up an additional 15%. These three sectors account for more than half of the MSCI USA Index, compared with 33% and 28% in MSCI's Japan and Europe indexes, respectively.

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U.S. stocks have rebounded more than 20% from the lows in late March, when decisive policy actions were announced to help bridge the economy through the coronavirus shock. This has helped them outperform other DM equities. We believe that the U.S. activity shortfall from the current economic standstill is initially likely to be more than twice as large as the global financial crisis. Yet over the longer horizon, the cumulative impact – the sum of activity lost every quarter relative to its pre-shock 2019 trend – will likely be less severe, as we argue in how large is the coronavirus macro shock? The reason is the historic U.S. policy response that includes a fiscal package of more than $2 trillion, and extraordinary measures from the Federal Reserve to cushion the economic and market impact of the coronavirus shock. The U.S. fiscal package is equivalent to about 10% of the U.S. gross domestic product (GDP), the largest among key DMs, and we believe there may be more to come. Overall, we see more policy room in the U.S. than in other DMs in coming months to help shore up the economy, but recognize that successful and timely execution of fiscal measures is a key risk everywhere, including in the U.S.

To be sure, the near-term picture for corporate earnings is dire as the first-quarter earnings season kicks off: Analysts expect Q1 earnings of S&P 500 companies to contract 7.3% year-on-year – the largest annual decrease since the third quarter of 2009 – according to FactSet. Yet earnings estimates for sectors with defensive characteristics or positive long-term growth prospects have held up much better than those of cyclical sectors. Q1 earnings of the communication services sector is expected to grow 8.8% on the year, versus a 41% decrease in energy, for example. Technology and healthcare are also among sectors with positive earnings growth estimates. In another sign of the defensive nature of these sectors, the dispersion of earnings forecasts across companies within them has risen much less than in many cyclical sectors.

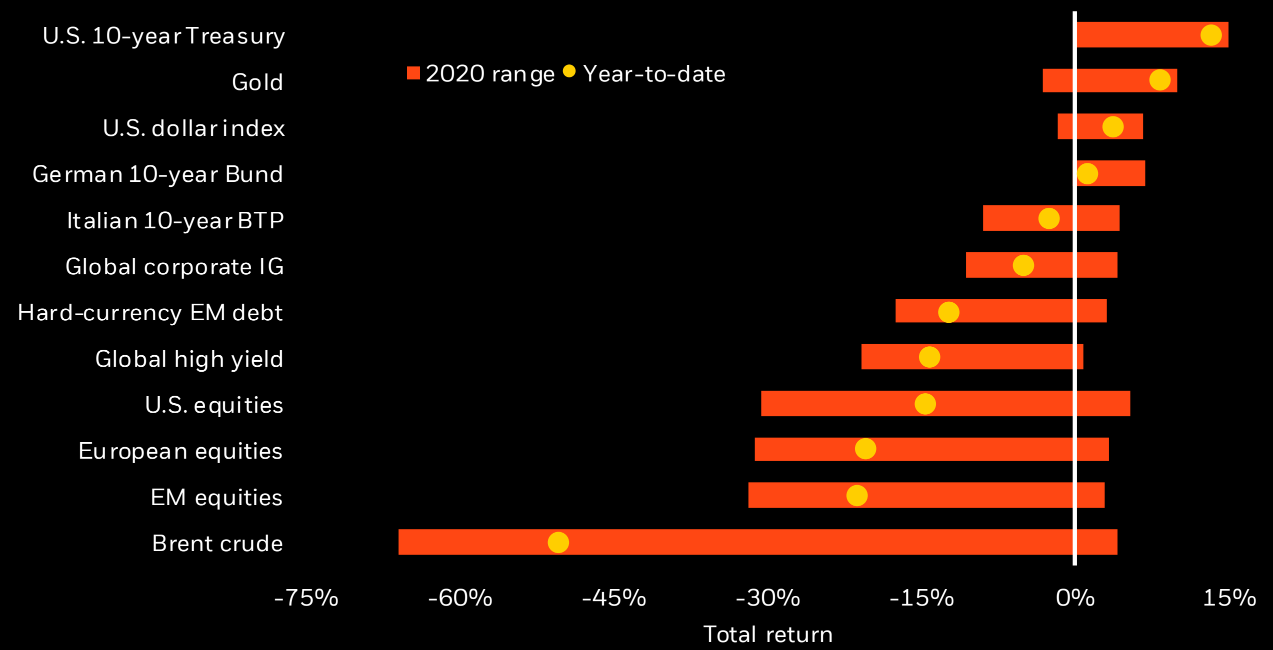
The bottom line: We prefer up-in-quality and up-the-capital-structure exposures, especially those with strong policy support, over the next six to 12 months. Within equity markets, that means a preference for the U.S. market and the quality and min vol style factors. We also prefer credit over equities given bondholders' preferential claim on corporate cash flows in a highly uncertain economic environment. We stay neutral on global equities on a tactical horizon, recognizing the wide uncertainties around the path of the outbreak in coming quarters, but see value for investors with long investment horizons.

Market backdrop

Fiscal and monetary policy action to bridge the economic impact of the coronavirus has taken shape – and now the key is policy execution to ensure households and businesses get the cash being promised. The Fed expanded its support for the economy with a $2.3 trillion loan program for local governments and small businesses. Tentative signs that the outbreak might be slowing in some U.S. hot spots helped lift U.S. stocks more than 10% last week. Former Vice President Joe Biden became the presumptive challenger to President Donald Trump in the November election after Bernie Sanders left the race.

Assets in review

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



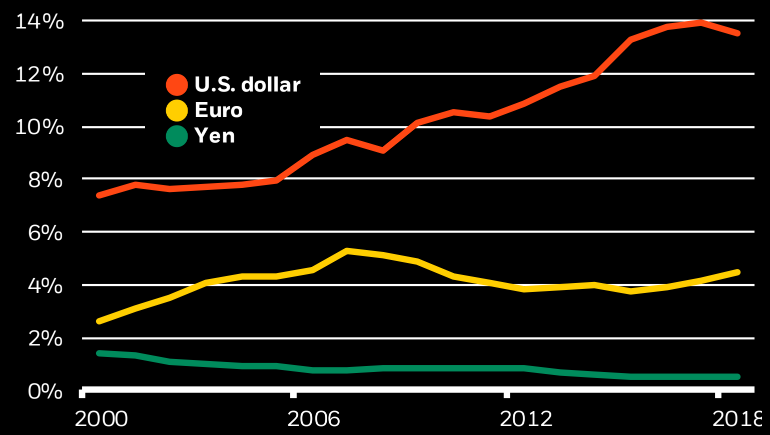
Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2020. Notes: The two ends of the bars show the lowest and highest returns versus the end of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

The appreciation of the U.S. dollar in recent weeks has prompted comparisons to the global financial crisis (GFC). But the dollar has gained even more share as an international funding currency since then. Dollar credit to nonbanks outside the U.S. has risen from 9% of global GDP in 2007 to 14% in 2018. And international credit denominated in euros and yen have both declined as a share of GDP. This suggests that liquidity policies by the Federal Reserve need to be even more far-reaching than during the GFC. The Fed has enhanced existing swap lines and established temporary swap lines with several central banks that previously did not have access to them, such as the central banks of Brazil and Mexico. Going further beyond arrangements introduced since the GFC, the Fed has also introduced a temporary repo facility that allows foreign monetary authorities to borrow U.S. dollars against Treasury holdings. So far, the combination of these measures appears to have eased the liquidity squeeze and the upward pressure on the dollar in advanced economies.

Dominant dollar

Credit to nonbanks outside U.S., 2000-2018



Sources: BlackRock Investment Institute, BIS, IMF, Federal Reserve, with data from Haver Analytics, April 2020. Notes: The chart shows international credit in the non-bank sector as a share of global GDP, in U.S. dollars, euros and yen. The credit amount is taken from BIS data, and IMF data is used to work out the share of global GDP. FX data from the Fed was used for currency conversions.

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, likely concentrated 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: the decisive policy response is not delivered in a successful and timely fashion, 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

- The Federal Reserve built on its "whatever it takes" approach to helping the economy through the coronavirus shock, announcing $2.3 trillion in new lending support to small business payrolls and local governments. U.S. policymakers are looking to add to the already passed $2 trillion fiscal support package to help small businesses.
- Fiscal policy 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. Euro area finance ministers look set to launch an array of measures providing broad support along similar lines – potentially including use of the European Stability Mechanism. Successful policy implementation is key now. Japan passed fresh stimulus taking its fiscal spending plans to about 10% of GDP.
- Some actions are raising questions about whether they may undermine the independence of central banks. The UK Treasury activated a funding facility for spending that will be directly financed by the Bank of England, rather than the gilt market, but called the move temporary.
- It's crucial to have proper guard rails around policy coordination, as we wrote in Dealing with the next downturn.
- Central banks have mostly alleviated the dysfunction of market pricing and tightening of financial conditions for now, with the European Central Bank relaxing its collateral rules last week. U.S. money market functioning has improved notably, but European money markets are still struggling from the ECB's limited direct involvement.
- **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. 14	China trade data	**Apr. 16**	Federal Reserve Bank of Philadelphia business outlook survey
Apr. 15	U.S. retail sales and industrial production	**Apr. 17**	China GDP, retail sales and industrial production

Markets are keen to gauge the order of magnitudes of the historic freeze of economic activity around the world. This week's U.S. retail sales and industrial output data for March will likely show the impact of the containment measures have had on the economy. The Philly Fed survey could give some indication of the impact on business growth in the short term.

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. Global economic activity has been almost halted in order to stem the spread of the coronavirus. Overwhelming and aggressive policy action – both fiscal and monetary – help support the asset class. We prefer an up-in-quality stance, and like economies with ample policy room. We 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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