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Weekly commentary

BlackRock

August 16, 2021

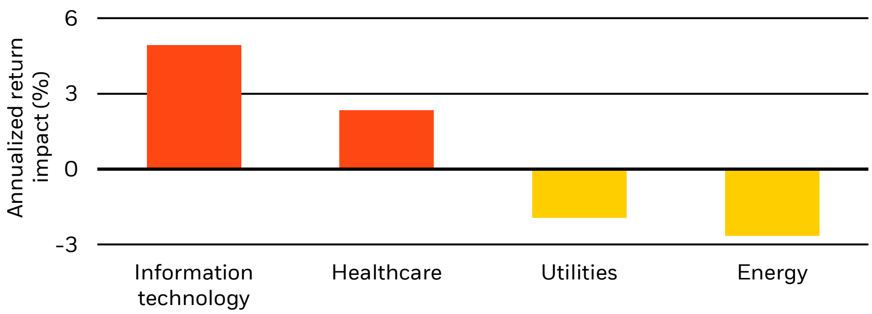
Don't ignore climate risks in portfolios

- We believe ignoring the effects of climate change on portfolios is not an option, and the window for investors to position portfolios may be shrinking.
- The U.S. Senate passed a $1.2 trillion infrastructure bill that now awaits a House vote. Congress will take up the $3.5 trillion spending plan after recess.
- Investors will focus on the minutes of the Federal Reserve's July policy meeting for details of any deliberations on asset purchase tapering.

Severe climate events around the world this year have intensified debate around the effects of climate change and the risks they pose to portfolios. Investors should no longer view the transition to a low-carbon economy as a distant event only, in our view, as it is happening here and now. 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, in our view.

Winners and losers

Equity return assumption change: green transition vs. no-climate-action



For illustrative purposes only. This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream and Bloomberg, August 2021. Notes: The chart shows the difference in U.S. dollar expected returns over the next five years from August 2021 for four sectors of the MSCI USA Index in our base case of a "green" transition (policies and actions taken to mitigate climate change and damages, and to limit temperature rises to no more than 2 degrees Celsius by 2100) vs. a no-climate-action scenario. The estimated sectoral impact is based on expected differences in economic growth, corporates earnings and asset valuations across the two scenarios. Professional investors can access full details in our Portfolio perspectives and CMAs website.

The latest report from the United Nations' Intergovernmental Panel on Climate Change (IPCC) confirmed the accelerating global warming. It assesses that greenhouse gas emissions from human activities are responsible for about 1.1 degree Celsius (or about 2 degrees Fahrenheit) of warming in average global temperatures since the 19th century, and the warming will continue for decades even if immediate actions are taken to sharply reduce emissions. The IPCC still sees a narrow window for limiting warming to 1.5 degree Celsius if there is a coordinated effort to achieve net-zero emission by 2050. Our climate-aware return assumptions assume a successful transition to a low-carbon economy consistent with Paris agreement goals, and that will deliver an improved outlook for growth and risk assets relative to doing nothing. We see climate-resilient sectors such as technology and healthcare likely benefitting the most from a "green" transition, and carbon-intensive sectors with less transition opportunities such as energy and utilities likely lagging. See the chart for return assumptions in our base case vs. a no-climate-action scenario.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Attention on climate change is running high – as extreme weather events have occurred frequently in recent years. The increasing frequency of these events will continue even if global warming is limited to 1.5 degree Celsius, according to the scientific consensus reflected by the IPCC. Severe heat waves that happened once every 50 years in the pre-industrial world are now happening roughly once a decade, and will likely occur once every six years in a 1.5 degree scenario, according to the report. This IPCC report, focused on the physical science of climate change, is one of the four the UN panel plans to release between now and September 2022. The other three will focus on the impact of climate change on society and on natural systems, as well as on the pathways to achieve net-zero emissions. Global governments are due to meet in late October at a key UN climate conference to discuss how to accelerate efforts to achieve their net-zero goals.

Extreme weather events have helped elevate climate risk to a key concern among investors. Consider the two baskets of climate risks: physical risks (think of hurricanes and wildfires and their potential damages to real assets) and transition risks (financial risks arising from the transition to net-zero, stemming from changes in taxes, regulation, technology and business models). The window for a successful transition to net-zero by 2050 – a goal set by many governments – is shrinking, as pointed out by the IPCC. We could see the window for positioning portfolios shrinking too. Accelerated actions to reach net-zero would drive transition risks to be more rapidly priced in by financial markets. Absent that, we would likely see continually accelerating physical risks as a result. Altogether, the pathway to net-zero remains a highly uncertain one, but regardless of the path taken, we see the implications on portfolios accelerating.

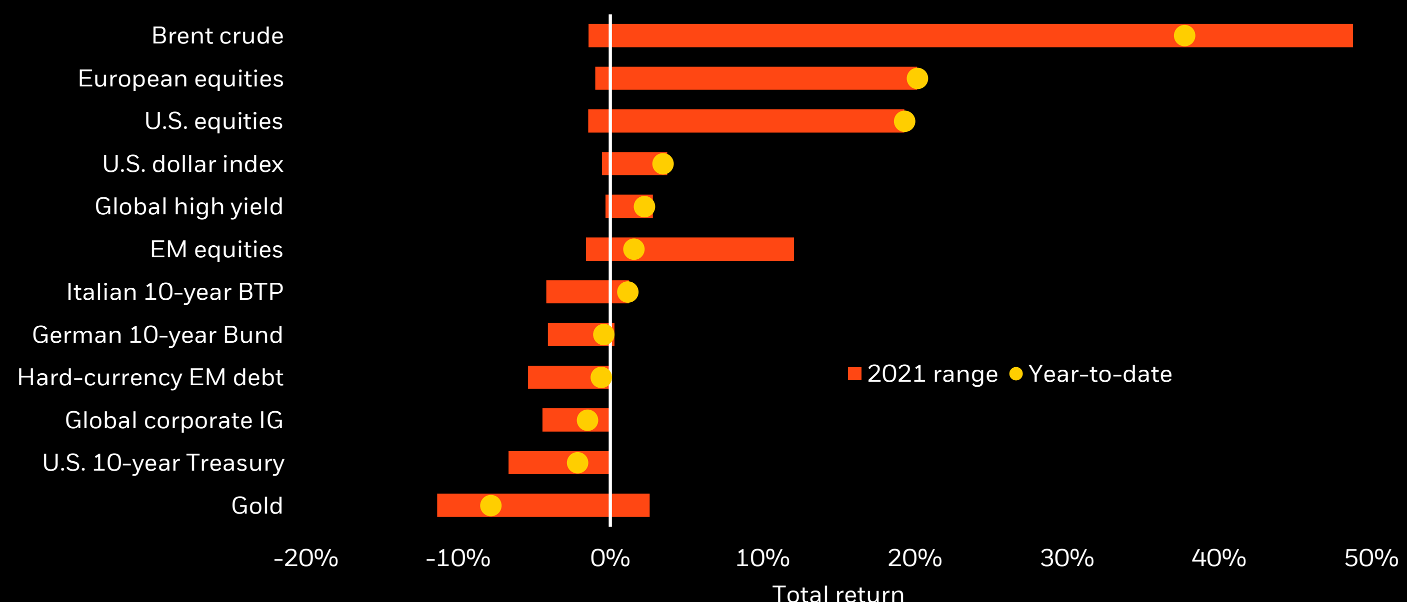
The bottom line: We are still in the early stages of a tectonic shift toward sustainable investing, and the full consequences of this shift are not yet in market prices. We expect "green" assets that are likely to benefit from the transition to a low-carbon economy to outperform during this shift. This is one reason for investors to keep tabs on the progress of climate change and that of climate transition. We see two key aspects in the climate transition: technology and policy. The tech transition has already begun in some key sectors such as utilities and autos, and as the window to achieve net zero by mid-century narrows, we expect policy levers to be pulled harder – and this could result in a steeper transition. We believe doing nothing about climate change in portfolios is no longer an option.

Market backdrop

The U.S. Senate approved the $1.2 trillion infrastructure bill that will now await a vote at the House of Representatives. Congress will take up the $3.5 trillion spending package covering healthcare, child and elder care, education, environment and other areas after the August recess. The two bills combined would likely provide a boost to annual growth of between 0.4-1.5 percentage point in 2022 and 2023, and have muted impact on medium-term inflation as higher spending will likely be offset by greater productivity, according to consensus expectations.

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 August 12, 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 Europe Index, MSCI USA Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, MSCI Emerging Markets Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream Germany 10-year benchmark government bond index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

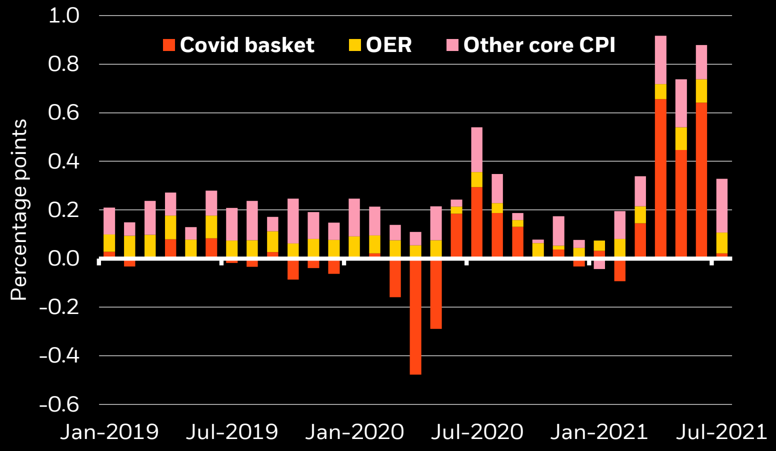
U.S. inflation increased slightly slower in July than in previous months, the latest consumer price index (CPI) data showed. This was a result of lower price pressures in some of the main contributors to CPI increases during the economic reopening so far, such as used cars. Yet there is also evidence of price pressures broadening out elsewhere, especially in restaurants and recreation. See the chart.

These short-term dynamics reflect ongoing supply and demand disruptions resulting from the economic restart, in our view, and should be seen as distinct from medium-term factors. It is the latter – including new central bank frameworks and higher production costs – that we see driving inflation close to a 3% annual rate over the coming years.

Federal Reserve officials are also starting to welcome higher inflation as helping it achieve its 2% average target and to anchor inflation expectations near that level. This underscores our *new nominal* theme - central banks will respond in a more muted way to inflation than they did in the past. See our macro insights hub.

Inflation make-up reflects restart

Component contributions to % core CPI, 2019-2021



Sources: BlackRock Investment Institute, Bureau of Labor Statistics, with data from Haver Analytics, August 2021. Notes: Bars show the percentage point contributions to the month-on-month change in the core consumer prices index. The Covid basket is a collection of items that we believe are most impacted by the reopening of the economy, and comprises apparel, lodging, airfares, used cars, auto insurance and car rentals. OER is owner-equivalent rent, a measure of the cost of owner-occupied housing. Other core CPI are all other items in the core CPI index.

Investment themes

1 The new nominal

- The powerful economic restart is broadening, with Europe and other major economies catching up with the U.S. We expect a higher inflation regime in the medium term – with a more muted monetary response than in the past.
- *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.
- We expect the Fed to start normalizing policy rates in 2023, a much slower pace than market pricing for lift-off in 2022 indicates. The market's lack of confidence in the Fed's commitment to its new framework poses a risk of tighter financial conditions in the near term. We would anticipate this uncertainty to dissipate over time – assuming the central bank regains control of its narrative – paving the way for us to lean even more tactically pro-risk.
- The ECB tweaked its forward guidance after having recently set its inflation target at 2% in the medium term but rejecting an average inflation targeting framework. The central bank said it would keep policy rates on hold until it had seen "inflation reaching 2% well ahead of the end of the projection horizon and durably for the rest of the projection horizon." We see this likely to be followed by an increase in the ECB's asset purchases later this year.
- **Tactical implication**: We go overweight European equities and inflation-linked bonds. We cut U.S. equities to neutral.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is already a distinct pole of global growth. We believe it is time to also treat it as an investment destination separate from EM and DM.
- Chinese authorities have started loosening policies as growth slows, yet we believe they will maintain the broadly hawkish policy stance over the medium term to stay focused on the quality of the growth.
- We believe the clampdown on some private industries could go on for years, but its intensity would likely fluctuate. We have yet to see the peak of the regulatory campaign, but could see its pace and intensity to moderate amid slower growth.
- 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 break out China from EM with a neutral stance on equities and an overweight to debt.
- **Strategic implication:** Our neutral allocation to Chinese assets is multiples larger than typical benchmark weights.

3 Journey to net zero

- There is no roadmap for getting to net zero, and we believe markets underappreciate the profound changes coming. 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 prices 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.

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Week ahead

Aug 16 China retail sales and industrial output

Aug 17 U.S. retail sales, industrial production

Aug 18 Federal Open Market Committee (FOMC) July meeting minutes; UK inflation

Aug 19 U.S. Philly Fed Manufacturing Business Outlook Survey

Investors will watch the minutes of the FOMC's July meeting for details of any deliberations on asset purchase tapering. The Philly Fed survey and retail sales data in the U.S. will also be in focus to gauge the state of the restart. Retail was a key laggard in the latest U.S. employment report, as brick and mortar retail still felt the pressure by the rise of e commerce amid growing concerns over the delta variant.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	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 cyclicality and maintain a quality bias.
Credit	**-1**	**Neutral**	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.
Govt bonds	**-1**	**-1**	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballast 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.
Cash		**Neutral**	We are moderately pro-risk and keep some cash to potentially further 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, August 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.

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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, August 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.
Equities	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.
Equities	Europe			We are overweight European equities on the back of the broadening restart. 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.
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 in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			While overweight on a strategic basis, we see near-term risks. Growth is slowing at the same time as policy stance is tight – and may not respond in a timely way as authorities focus on the quality of growth. The anti-monopoly clampdown is ongoing.
Equities	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.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. The anti-monopoly clampdown in the heavyweight Chinese tech sector 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 tilting toward gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	China government bonds			We initiate a view on Chinese government bonds with an overweight. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We remain underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield credit after the asset class' strong performance. Spreads are now below where we see high yield as attractively valued. 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 neutral local-currency EM debt. and 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, in our view.
Fixed 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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