Weekly commentary

May 3, 2021

BlackRock

Jean Boivin
Head – BlackRock Investment Institute

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

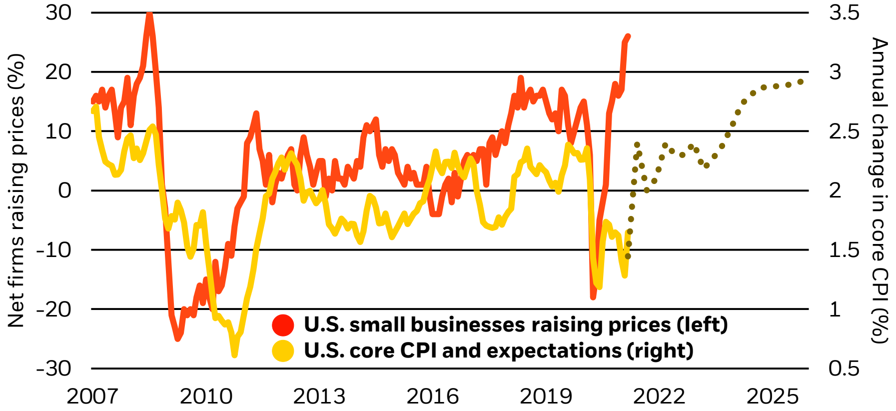
Inflation: beyond near-term volatility

- We see near-term volatility in inflation as the economic restart progresses, and believe markets underappreciate potential for medium-term price pressures.
- U.S. stocks hit record highs supported by strong corporate earnings. The Federal Reserve reiterated its intent to "stay behind the curve."
- Investors will look for clues of the recovery of sectors most affected by the pandemic in this week's U.S. nonfarm payrolls data.

Inflation looks set to overshoot the Fed's target as we have expected. Yet we see uncertainties around the near-term persistence of the overshoot as the restart leads to unusual supply and demand dynamics. We have closed our tactical overweight in inflation-linked bonds as inflation expectations have risen sharply, but favor them strategically as we see medium-term inflation still underpriced.

Chart of the week

U.S. firm price trends and core consumer price index (CPI), 2007-2025



Forward looking estimates may not come to pass. Sources: BlackRock Investment Institute, U.S. National Federation of Independent Business, Bureau of Labor Statistics, Reuters News, with data from Haver Analytics, April 2021. Notes: The orange line shows the net balance of firms in the NFIB survey of small and medium-sized businesses reporting that they are currently raising their prices. A value of 0 indicates that the number of firms raising and reducing their prices is the same. The solid yellow line shows the annual change in the U.S. core CPI inflation rate. The dotted line indicates estimates for core CPI. Expected values for 2021-22 are based on the Reuters consensus as of March 2021. The core CPI estimates from 2022 onwards are based on our expectations of the likely path of GDP growth, spare capacity in the economy and the outlook for monetary policy.

The Covid shock is more akin to a natural disaster followed by a rapid "restart" – rather than a traditional business cycle recession followed by a "recovery", in our view. We see this distinct nature of the shock as having profound implications for inflation: The pandemic didn't cause a shortfall in demand as in typical recessions; it has instead led to shortfalls in both supply and demand. As the economy restarts, both supply bottlenecks and pent-up demand are coming into sharp focus. Small U.S. businesses slashed prices at the onset of the pandemic, coinciding with a dip in the core consumer price index (CPI), or prices excluding those of volatile energy and food. See the chart above. The trend has since turned, with many small businesses raising prices. Consensus forecasts point to a peak of inflation in May, yet we believe inflation could be volatile in the near term and see risks to the upside given the unusual interplay between supply bottlenecks and pent-up demand as the restart plays out.

Visit BlackRock Investment Institute for insights on global economy, markets and geopolitics.

BlackRock **Investment** Institute

Right now we are witnessing supply constraints being pitted against surging demand as the economy reopens. Global supply chains have come under pressure during the pandemic, as companies are faced with challenges including component shortages, rising raw material prices and longer delivery times. Meanwhile we expect the pent-up demand to unleash as virus restrictions ease and activity reopens. This unusual dynamic could lead to volatile inflation in the near term, in our view. In addition, it could allow many companies more power to pass on higher input prices to consumers with cash to spare, preventing compression in profit margins.

We have closed our tactical overweight in Treasury Inflation-Protected Securities (TIPS) after sharp increases in both inflation expectations and nominal bond yields. The 10-year breakeven inflation rate – a market-based measure of inflation expectations – has risen from 0.5% last March to about 2.4%. It has also become less responsive to recent inflation data surprises. We don't see it moving significantly above 2.5% in coming months. Net inflows to TIPS exchanged-traded products (ETPs), on a rolling six-month basis, have hovered near record levels hit last December, according to Bloomberg.

We see U.S.CPI inflation averaging just under 3% between 2025-2030, and we believe this is still underpriced by markets. First, we expect higher production costs as the pandemic accelerates the rewiring of global supply chains. Second, major central banks are evolving their policy frameworks and explicitly intend to let inflation overshoot their targets. Third, the higher debt levels will make it harder for central banks to lean against inflation – and make the decision to start tightening more politicized, in our view. When looking at the concrete impact of higher debt servicing costs due to tightening monetary policy, the less tangible – but no less real – risk of loosening the grip on inflation expectations will likely pale in comparison.

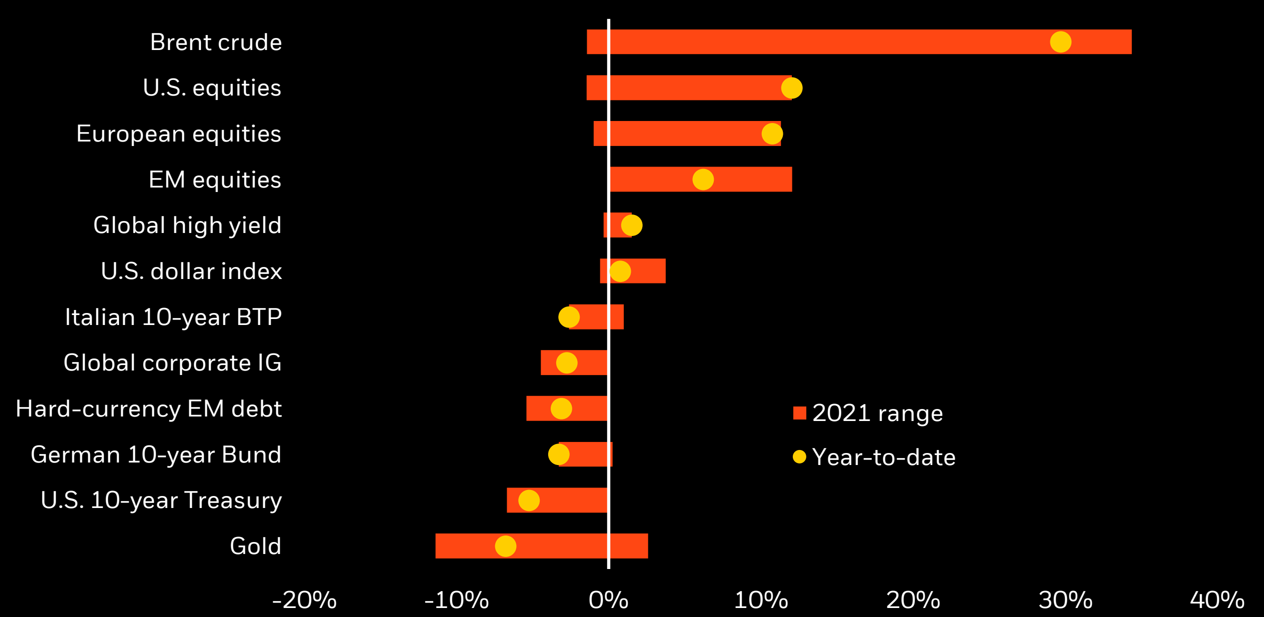
The bottom line: We will likely see peak growth data and volatile inflation data in coming months – different from typical business cycle recoveries where better growth data typically have led to higher inflation. This may trigger some knee-jerk reactions and market volatility. We believe markets are still underestimating the potential for above-target inflation over the medium term. As a result we prefer inflation-linked bonds and are underweight nominal government bonds over the strategic horizon.

Market backdrop

A decline in U.S. Treasury yields and strong corporate earnings are providing some support to equities. The S&P 500 Index hit a record high last week and posted gains for the third straight month. Among the just over 40% of S&P 500 companies that have reported first-quarter earnings, 85% have beaten estimates, Refinitiv data showed. Mega-cap tech companies reported strong results. President Joe Biden outlined his $4 trillion spending plan to enhance infrastructure and social services, and the Fed reinforced its emphasis on policy patience.

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 April 29, 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, MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, ICE U.S. Dollar Index (DXY), Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, J.P. Morgan EMBI index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and spot gold.

Macro insights

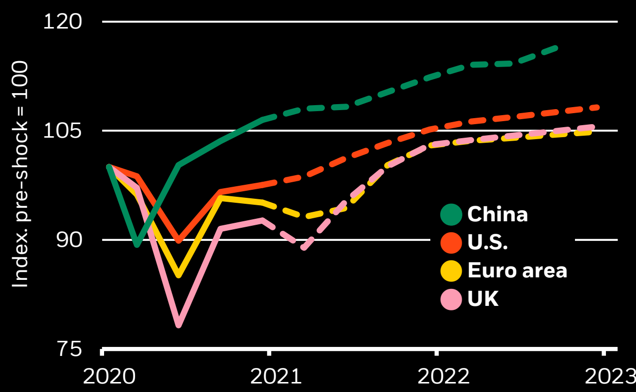
Vaccine rollouts and ensuing economic reopening hold the key to shaping the restart. Improving virus and vaccine dynamics should pave the way to a consumer-led resumption of activity, in our view.

We see global growth evening out over time amid broadening vaccine rollouts, after the staggered restart across countries. Vaccinations have been faster than expected in the U.S. and UK, and the pace in the euro area is poised to pick up after a sluggish start. China is also ramping up its vaccine rollout after having managed to keep infection rates low. These dynamics translate into a staggered restart in activity around the globe – with China's growth having returned to its pre-Covid trend at the end of 2020. See the chart.

The accelerated restart is confirming our view that the cumulative loss from the Covid shock will be far smaller than was feared a year ago. Current estimates peg the cumulative loss at around 8% in the U.S. and just under 20% in the euro area. This is less than one-fifth of the losses from the Global Financial Crisis. See our macro insights hub for more.

Evening out

Actual and estimated GDP paths, 2020-2023



Sources: BlackRock Investment Institute, Markit, with data from Refinitiv Datastream and Haver Analytics, April 2021. Notes: The chart shows the actual (solid lines) and estimated paths (dotted lines) of real GDP in the U.S., euro area, UK and China. Estimates are based on the latest available Reuters consensus and include the estimated impact of U.S. fiscal stimulus and European lockdown restrictions.

Investment themes

1 The new nominal

- We see the U.S. and UK leading the developed world's economic restart, powered by pent-up demand and sky-high excess savings. The huge growth spurt will be transitory, in our view. This is because a restart is not a recovery: the more activity restarts now, the less there will be to restart later.
- Our *new nominal* theme – that nominal yields will be less sensitive to expectations for higher inflation – was confirmed by the Fed's March policy meeting. The Fed made it clear that the bar for reassessing its policy rate path was not met and that it was too soon to talk about tapering bond purchases. We believe this clear reaffirmation of its commitment to be well "behind the curve" on inflation has helped the Fed regain control of the narrative – for now.
- We believe the recent rise in nominal government bond yields, led by real yields, is justified and reflects markets awakening to positive developments on the faster-than-expected activity restart combined with historically large fiscal stimulus – all helped by a ramp-up in vaccinations in the U.S.
- We expect short-term rates will stay anchored near zero, supporting equity valuations. The Fed could be more willing to lean against rising long-term yields than the past, yet the direction of travel over the next few years is clearly towards higher long-term yields. We see important limits on the level of yields the global economy can withstand.
- **Market implication**: We favor inflation-linked bonds amid inflationary pressures in the medium term. Tactically we prefer to take risk in equities over credit amid low rates and tight spreads.

2 Globalization rewired

- Covid-19 has accelerated geopolitical transformations such as a bipolar U.S.-China world order and a rewiring of global supply chains, placing greater weight on resilience.
- The Biden administration is engaging in strategic competition with China, particularly on technology, and has criticized Beijing on human rights issues. The tensions were on display in a bilateral diplomatic meeting in Alaska.
- We see assets exposed to Chinese growth as core strategic holdings that are distinct from EM exposures. There is a case for greater exposure to China-exposed assets for potential returns and diversification, in our view.
- We expect persistent inflows to Asian assets as we believe many global investors remain underinvested and China's weight in global indexes grows. Risks to China-exposed assets include China's high debt levels and U.S.-China conflicts, but we believe investors are compensated for these risks.
- **Market implication**: Strategically we favor deliberate country diversification and above-benchmark China exposures. Tactically we like Asia ex-Japan equities, and see UK equities as an inexpensive, cyclical exposure.

3 Turbocharged transformations

- The pandemic has added fuel to pre-existing structural trends such as an increased focus on sustainability, rising inequality within and across nations, and the dominance of e-commerce at the expense of traditional retail.
- The pandemic has focused attention on underappreciated sustainability-related factors and supply chain resilience.
- It has also accelerated "winner takes all" dynamics that have led to the strong performance of a handful of tech giants in recent years. We see tech as having long-term structural tailwinds despite its increased valuations, yet it could face challenges from higher corporate taxes and tighter regulation under a united Democratic government.
- The pandemic has heightened the focus on inequalities within and across countries due to the varying quality of public health infrastructure – particularly across EMs – and access to healthcare.
- **Market implication**: Strategically we see returns being driven by climate change impacts, and view developed market equities as an asset class positioned to capture the opportunities from the climate transition. Tactically we favor tech and healthcare as well as selected cyclical exposures.

Week ahead

May 3	U.S., euro zone manufacturing purchasing managers' index (PMI)
May 5	U.S. ISM non-manufacturing PMI; euro zone composite PMI
May 6	Bank of England policy meeting
May 7	Caixin China services PMI; U.S. nonfarm payrolls

U.S. nonfarm payrolls data will be in focus. Economists expect an increase of 978,000 jobs in April, after a rise of 916,000 jobs in the previous month, according to Reuters. Investors will look for clues on the rebound of sectors that have been most affected by the pandemic as well as a further increase in construction jobs. They will also try to gauge the pace of the economic restart from PMI data from key economies.

Directional views

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

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	We are 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 indexes. 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 bias for quality.
Credit	**-1**	**Neutral**	We are underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, credit, especially investment grade, has come under pressure from tightening spreads, but we still like high yield for income.
Govt bonds	**-1**	**-1**	We are strategically underweight nominal government bonds as their ability to act as portfolio ballasts are diminished with yields near lower bounds and 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 as we see risks of higher inflation in the medium term. We are underweight duration on a tactical basis as we anticipate gradual increases in nominal yields supported by the economic restart.
Cash		**Neutral**	We use cash to fund overweight in equities. Holding some cash makes sense, in our view, as a buffer against supply shocks driving both stocks and bonds lower.
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 not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, April 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, April 2021

	Asset	Underweight	Overweight	
Equities	United States			We are overweight U.S. equities. We see the tech and healthcare sectors offering exposure to structural growth trends, and U.S. small caps geared to an expected cyclical upswing in 2021.
	Euro area			We are neutral European equities. We believe the broad economic restart later in the year will help narrow the performance gap between this market and the rest of the world.
	Japan			We are underweight Japanese equities. Other Asian economies may be greater beneficiaries of a more predictable U.S. trade policy under a Biden administration. A stronger yen amid potential U.S. dollar weakness may weigh on Japanese exporters.
	Emerging markets			We are overweight EM equities. We see them as principal beneficiaries of a vaccine-led global economic upswing in 2021. Other positives: our expectation of a flat to weaker U.S. dollar and more stable trade policy under a Biden administration.
	Asia ex-Japan			We are overweight Asia ex-Japan equities. Many Asian countries have effectively contained the virus – and are further ahead in the economic restart. We see the region's tech orientation allowing it to benefit from structural growth trends.
	UK			We are overweight UK equities. The removal of uncertainty over a Brexit deal should see the risk premium on UK assets attached to that outcome erode. We also see UK large-caps as a relatively attractive play on the global cyclical recovery as it has lagged peers.
	Momentum			We keep momentum at neutral. The factor has become more exposed to cyclicality, could face challenges in the near term as a resurgence in Covid-19 cases and a slow start to the vaccination efforts create potential for choppy markets.
	Value			We are neutral on value despite recent underperformance. The factor could benefit from an accelerated restart, but we believe that many of the cheapest companies – across a range of sectors – face structural challenges.
	Minimum volatility			We turn neutral min vol. Our regional and sectoral preferences warrant a higher exposure to the factor. Min vol's underperformance has brought valuations to more reasonable levels in our view.
	Quality			We are overweight quality. We like tech companies with structural tailwinds and see companies with strong balance sheets and cash flows as resilient against a range of outcomes in the pandemic and economy.
	Size			We are overweight the U.S. size factor. We see small- and mid-cap U.S. companies as a key place where exposure to cyclicality may be rewarded amid a vaccine-led recovery.
Fixed Income	U.S. Treasuries			We trim our underweight to U.S. Treasuries by one notch following the sharp move up in yields in response to the accelerated economic restart. We prefer to stay underweight as we expect short-term rates will stay anchored near zero.
	Treasury Inflation-Protected Securities			We turn neutral TIPS following the sharp rise in inflation expectations since late year. Further increases seem unlikely in the near-term. We still see inflation pressures building over the medium term due to structural reasons.
	German bunds			We are neutral on bunds. We see the balance of risks shifting back in favor of more monetary policy easing from the European Central Bank as the regional economic rebound shows signs of flagging.
	Euro area peripherals			We are neutral euro peripheral bond markets. Yields have rallied to near record lows and spreads have narrowed. The ECB supports the market but it is not price-agnostic - its purchases have eased as spreads have narrowed.
	Global investment grade			We are underweight investment grade credit. We see little room for further yield spread compression and favor more cyclical exposures such as high yield and Asia fixed income.
	Global high yield			We are moderately overweight global high yield. Spreads have narrowed significantly, but we believe the asset class remains an attractive source of income in a yield-starved world.
	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.
	Emerging market – local currency			We upgrade EM local debt to overweight as its year-to-date underperformance has left valuations more appealing, particularly if U.S. Treasury yields and the U.S. dollar stabilize. We see limited contagion to broader EM from selected country-specific volatility.
	Asia fixed income			We are overweight Asia fixed income. We see the asset class as attractively valued. Asian countries have done better in containing the virus and are further ahead in the economic restart.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Note: Views are from a U.S. dollar perspective. 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.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee