
Time to overweight equities: BlackRock

By No Author Wed, Nov 25, 2020

'A key risk to our US equities view: The winding down of key Fed/Treasury emergency support facilities by the US Treasury highlights risks ahead for overall US policy support, especially on additional fiscal relief,' write analysts at BlackRock Investment Institute.



We upgrade US equities to over-weight, with a preference for quality large caps riding structural growth trends as well as smaller companies geared to a potential cyclical upswing. We prefer to look through any near-term market volatility as Covid cases surge. Positive vaccine news reinforces our outlook for an accelerated restart during 2021, reducing risks of permanent economic scarring. The pandemic has accelerated some key structural trends, such as increased flows into sustainable assets and the dominance of big tech companies.

The US market has a favorable sector composition compared with other major equity markets. It boasts a higher share of quality companies – those with strong balance sheets and free cash flow generation – in sectors backed by long-term growth trends such as tech and healthcare.

Information technology and communication services represent nearly 40% of the market value of the MSCI USA Index, compared with just 11% in Europe. See the chart at right. The US tech sector is about more than just the handful of mega-caps that have led market performance in recent years and face heightened regulatory scrutiny. Semiconductor and software companies, for example, face few regulatory risks and enjoy long-term growth trends.

The financial sector – under pressure from the low interest rate environment globally – represents a relatively small slice of the US market in comparison to Europe. Markets have been weighing a near-term resurgence in Covid cases against advancing vaccine development. We expect rising infections and new restrictions to cause activity contraction in Europe in the fourth quarter, with the US close behind.

Meanwhile China is set to return to its pre-Covid growth trend thanks to better virus control, boding well for the rest of Asia and emerging markets (EMs). The challenging months ahead in the US and Europe could support the case for further outperformance of

large-cap tech and healthcare companies.

At the same time, prospects for an accelerated economic restart during 2021 could favor more cyclical exposures. Should investors stick to quality - a perennial recent winner - or rotate into beaten down cyclical exposures?

We believe this is not an “either/or” question - and advocate a more nuanced approach. A “barbell” strategy that includes allocations on one side to quality companies benefiting from structural growth trends; and on the other to selected cyclical exposures. This can help achieve greater portfolio resilience amid still high levels of uncertainty about vaccine deployment and the prospects for further pandemic relief, we believe.

Our tactical upgrade to US equities and long-held preference for the quality factor are how we choose to gain exposure to structural growth. We take a selective approach to cyclical exposures, with over-weights in EM equities; Asia ex-Japan equities and the US size factor, which tilts toward mid- and small-cap companies. EMs should benefit from a global cyclical upswing in 2021 as well as more predictable US trade policies under President-elect Joe Biden.

The size factor is geared to a US cyclical upswing. We prefer avoiding more structurally challenged cyclical exposures. We have downgraded European equities to underweight and hold an underweight in Japanese equities. The European market has a relatively high exposure to financials, which we see pressured by low rates. Japan may not benefit as much as other Asian countries from a cyclical upswing, and could see its currency driven up by a weaker dollar - a result of monetary easing and more stable trade policy under a Biden administration.

Bottom line: We see the vaccine development providing a constructive backdrop for risk assets as we approach 2021, but advocate a balanced approach: quality companies that should outperform even if fiscal support disappoints; and selected cyclical exposures that are likely to thrive as the timeline for widespread vaccine deployment advances.

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Markets have been weighing the near-term Covid resurgence against positive news on long-term vaccine development. Effective vaccines would allow a broader opening-up of activity sooner and reduce the risk of long-term scarring. This reinforces our view that the cumulative economic hit from the Covid shock will be just a fraction of that seen in the wake of the global financial crisis. Yet we do see potential for near-term disruption to the economic restart caused by the ongoing virus resurgence and government restrictions.

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