BlackRock
Investment
Institute

Portfolio construction

Capital market assumptions

U.S. DOLLAR | AUGUST 2020

Data as of 30 June 2020

BlackRock

Summary

The Covid 19 shock has supercharged structural trends – deglobalization, the joint fiscal monetary policy revolution and sustainability – that require a larger overhaul of strategic asset allocations (SAAs) rather than a simple tweaking at the edges, in our view. Risk assets have staged a sharp rebound off their lows from the Covid-19 shock in the first quarter. The joint fiscal and monetary policy revolution helped allay some fears that the near-term economic shock would translate into permanent economic scarring. We took an early read on how market developments could impact our CMAs and asset views in our March *Portfolio perspectives*. We now have updated our Capital market assumptions (CMAs) and investor-specific portfolios at the end of the second quarter. We see a long-lasting impact of the policy revolution, especially on fixed income. Five-year expected government bond returns remain negative across developed markets as yields have fallen. The snapback in investment grade (IG) credit spreads – to pre-shock levels in some regions - has eroded expected returns for the asset class compared to our last update. IG spreads no longer provide adequate compensation for the rise in default and downgrade risk, in our view. Expected equity returns have also fallen as prices rose faster than the more gradual improvement we expect in corporate earnings. We see a significant drop in earnings this year before a gradual reversion begins toward the prior trend over coming years.

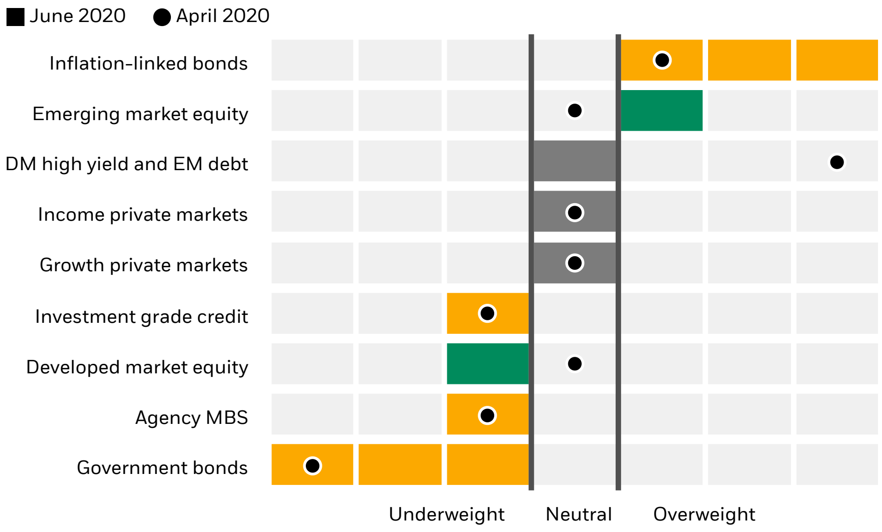
BlackRock strategic views

Our strategic asset class views show our asset class preferences over a 10-year horizon relative to a long-term, cycle-agnostic equilibrium asset allocation. We also contrast our strategic preferences with representative multi-asset portfolios in the U.S., euro area and UK. Based on our cyclical views and current market valuations, asset classes may be more or less favorable compared with a long-run, steady-state environment. The chart below summarizes our current views. The changes reflect our *Midyear investment outlook*: decreased allocations for nominal government bonds, a preference for inflation-linked bonds, private markets as portfolio diversifiers, and deliberate geographical exposures to prepare for a bifurcated world with two poles of growth – one U.S.-centric and one-China centric. We maintain our strong underweight in developed market government as the strategic case for developed market government bonds has diminished further since we first laid out our argument in *Bonds and ballast: testing the limits*. We find inflation-linked bonds and Chinese government bonds as increasingly attractive as part of a whole-portfolio approach to resilience. One important consequence of the policy revolution that we believe markets are underappreciating is the potential for higher inflation over the medium term. A challenging backdrop for corporate fundamentals has meaningful implications for our equity and credit views. We trim our credit overweight to neutral to account for a less-favorable view on IG credit. We still like selected high yield for income potential in a low-return world but have trimmed our overweight slightly. We stick to a neutral stance on equities with a tilt toward emerging markets, particularly China. We see private markets playing a core role in modern portfolios. Our investor-specific asset allocations typically have greater allocations to private markets than many similar multi-asset portfolios. Sizing allocations depends on client specifics such as cashflow requirements and manager selection.

BlackRock strategic views

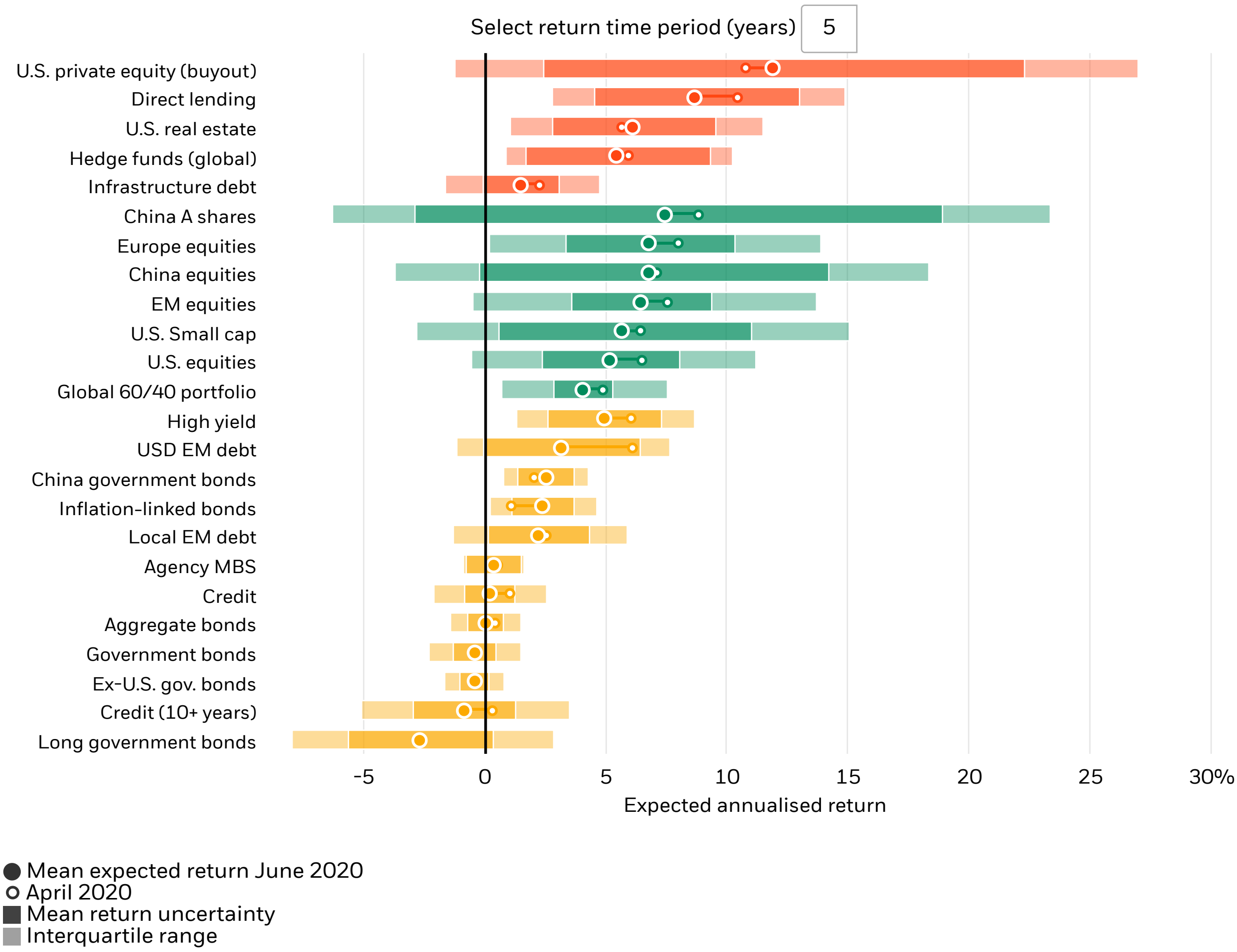
Strategic tilt

Hypothetical US dollar 10-year strategic allocation vs. our equilibrium view



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.
Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.
Notes: The equilibrium view tab shows our asset views on a 10-year view from an unconstrained US dollar perspective against a long-term equilibrium allocation. Income private markets include infrastructure debt, direct lending, real estate mezzanine debt and US core real estate. Growth private markets include global private equity buyouts and infrastructure equity. The hypothetical portfolio may differ from those in other jurisdictions, is intended for information purposes only and does not constitute investment advice.

Asset return expectations and uncertainty



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Source: BlackRock Investment Institute, August 2020. Data as of 30 June, 2020.
Notes: Return assumptions are total nominal returns. US dollar return expectations for all asset classes are shown in unhedged terms, with the exception of global ex-US Treasuries and hedge funds. Our CMAs generate market, or beta, geometric return expectations. Asset return expectations are gross of fees. For a list of indices used, visit our Capital Market Assumptions website at blackrock.com/institutions/en-us/insights/portfolio-design/capital-market-assumptions and click on the information icon in the *Asset class return and volatility expectations* table. We use BlackRock proxies for selected private markets because of lack of sufficient data. These proxies represent the mix of risk factor exposures that we believe represents the economic sensitivity of the given asset class. There are two sets of bands around our mean return expectation. The darker bands show our estimates of uncertainty in our mean return estimates. The lighter bands are based on the 25th and 75th percentile of expected return outcomes – the interquartile range for more detail read Portfolio perspectives. Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of any fund or strategy's performance. It is not possible to invest directly in an index.

Assumptions at a glance

Asset	Return expectations (geometric, gross of fees)				Long-term expected volatility	Long-term correlation	
	5-year	10-year	15-year	20-year		Global equities	Global government bonds
U.S. high yield	4.9%	5.1%	5.3%	5.3%	8.6%	63%	-2%
USD EM debt	3.1%	3.8%	4.4%	4.8%	10.2%	42%	37%
China government bonds	2.5%	2.7%	2.8%	2.9%	4.1%	-3%	29%
U.S. inflation-linked government bonds	2.4%	2.7%	2.9%	3.0%	5.9%	1%	52%
Local currency EM debt	2.2%	2.6%	2.9%	3.1%	9.2%	53%	11%
U.S. cash	0.5%	1.1%	1.6%	1.9%	0.0%	0%	0%
U.S. agency MBS	0.3%	1.0%	1.5%	1.8%	1.6%	-23%	39%
U.S. credit (all maturities)	0.2%	1.3%	2.3%	3.0%	6.9%	27%	57%
U.S. aggregate bonds	0.0%	0.8%	1.6%	2.0%	4.2%	-11%	76%
U.S. government bonds (all maturities)	-0.4%	0.3%	1.0%	1.5%	5.5%	-37%	76%
Global ex-U.S. government bonds	-0.4%	0.4%	1.2%	1.7%	3.5%	-17%	100%
U.S. credit (10+ years)	-0.9%	0.7%	2.1%	3.1%	12.4%	23%	60%
U.S. government (10+ years)	-2.7%	-1.6%	-0.5%	0.2%	15.2%	-31%	76%
China A shares	7.4%	7.3%	7.1%	6.9%	31.0%	34%	-7%
Europe large cap equities	6.8%	7.1%	7.4%	7.5%	18.2%	88%	-11%
China-Broad market equities	6.7%	7.8%	8.7%	9.3%	26.6%	52%	-10%
Global ex-U.S. large cap equities	6.7%	7.0%	7.2%	7.3%	16.2%	91%	-11%
Emerging large cap equities	6.4%	7.3%	8.0%	8.4%	20.6%	76%	-9%
U.S. small cap equities	5.7%	6.3%	6.8%	7.2%	22.0%	87%	-17%
U.S. large cap equities	5.2%	5.8%	6.4%	6.8%	16.3%	87%	-13%
U.S. private equity (buyout)	11.9%	12.1%	12.3%	12.4%	31.1%	80%	-20%
Global direct lending	8.7%	8.9%	9.0%	9.1%	14.3%	73%	-11%
Global infrastructure equity	8.2%	8.3%	8.3%	8.3%	18.8%	64%	5%
U.S. core real estate	6.1%	6.3%	6.4%	6.4%	12.2%	57%	16%
Real estate mezzanine debt	5.8%	6.2%	6.5%	6.6%	10.7%	69%	9%
Hedge funds (global)	5.4%	5.9%	6.3%	6.5%	8.1%	87%	-17%
U.S. Infrastructure debt	2.1%	3.2%	4.3%	4.9%	10.5%	28%	47%
Developed infrastructure debt	1.5%	2.5%	3.4%	3.9%	9.0%	31%	47%

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BlackRock Investment Institute

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