iShares

Fall 2021 Investment Directions

Insights from BlackRock

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Overview

More time at home has, for many of us, meant more time with our families (for some maybe even more than we'd like). But not all together time is quality time, as any parent of a teenager can vouch. That's because quality time is thoughtful and deliberate: higher standards are applied to quality time than simply passing time, and the same is increasingly being demanded of investment opportunities.

The through line that runs between all corners of the financial markets – and uncoincidentally throughout this piece - is a near-universal gravitation toward quality. As America's powerful economic restart moderates, we focus on quality in both U.S. equity and fixed income allocations, while maintaining above-average exposure to regions gaining economic momentum, like Europe and Canada. On the other side of the globe, China is undertaking major reforms to refocus on the quality, and not just the quantity, of economic growth. This piece reflects BlackRock Investment Institute and iShares Investment Strategists' take on how these themes are playing out across asset classes:

Canadian equities: Cyclicality and dividends

After a delayed vaccine rollout in Canada, the activity restart has arrived and is gaining momentum. This is particularly beneficial for Canadian stocks, where more than 70% of the market cap is defined as being cyclical in nature. The higher dividend yield, strong expected earnings growth and cheaper valuations also augur well for Canadian equities.

U.S. equities: Equities, earnings and the economic restart

Peak growth may be behind us, but that has not derailed the U.S. equity market. While U.S. equities can provide - and in our analysis often have provided – positive returns in mid-cycle periods, there is cause to be selective as dispersion among sectors and industries historically has risen.

International equities: Quality over quantity

China's recent regulatory crackdown rattled markets, but is likely to moderate, counterbalanced by a dovish shift in macro policy and a new focus on quality rather than quantity of growth. This may be beneficial to long-term growth, supporting our strategic case for China.

Fixed income: The new role of bonds in a balanced portfolio

Against the backdrop of historically low yields and the rising correlation of bond and equity markets, we believe that it's time to rethink the role of fixed income. We favor a disaggregated approach to the Universe Bond Index, seeking quality in credit, and limiting duration in line with our view for fundamentally driven higher rates by year-end.

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Factors: Quality focus

Our belief that we are entering a mid-cycle environment supports our preference for quality stocks. Still-strong growth rates will continue to support cyclical, value-oriented companies, but we favor hedging potential slowdowns with quality exposures that exhibit a lower beta to economic growth.

Canadian equities: Cyclicality and dividends

Key points

1. Growth momentum arrives in Canada as restart takes hold amid high vaccination rates.
2. Canadian stocks contain more cyclical sector exposure than global benchmarks.
3. Dividends a more important return source in yield-starved world.

Macro waves

After a frustratingly late start, the share of Canada's population that is fully vaccinated has risen to 70% as of Sept 23, 2021 (Figure 1). This high rate of vaccination has helped to limit the most recent rise in Covid cases, even though thinly vaccinated regions of Canada have seen increased numbers of new cases. Economists expect Canadian GDP to advance nearly 4.2% over the coming 12 months as the country reemerges from lockdown with high rates of excess savings and pent-up demand.[1] Employment has returned to its pre-pandemic level as of September 2021, and the unemployment rate has fallen to 6.9% from a pandemic peak of 13.7% in June 2020.[2]

The improved macro backdrop and higher inflation supports the Bank of Canada's (BoC) decision to unwind its pandemic-era policies. Ending asset purchases is a stated prerequisite for raising policy rates, which market participants expect to begin in the second half of 2022. With a tougher stance on inflation than the Fed and the ECB, the BoC is being forced to be as dovish as its framework allows by forecasting inflation to remain above 2% at the end of its forecast window rather than easing back to the midpoint of its 1-3% target range.[3] The BoC's relatively more hawkish stance will likely imply further strength in the Canadian dollar, provided oil prices and risk asset prices remain firm.

After several years of underperformance, Canadian stocks have risen in line with U.S. and global stocks during 2021, led by energy, financials and tech sector gains. A global activity restart is particularly beneficial for Canadian stocks, where more than 70% of the market cap is defined as cyclical in nature. Strong expected earnings growth and cheaper valuations augur well for Canadian equities in this environment. Moreover, according to MSCI, Canadian stocks offer a dividend yield advantage over other developed equity markets of over 90 basis points – valuable income in a yield-starved world.[4]

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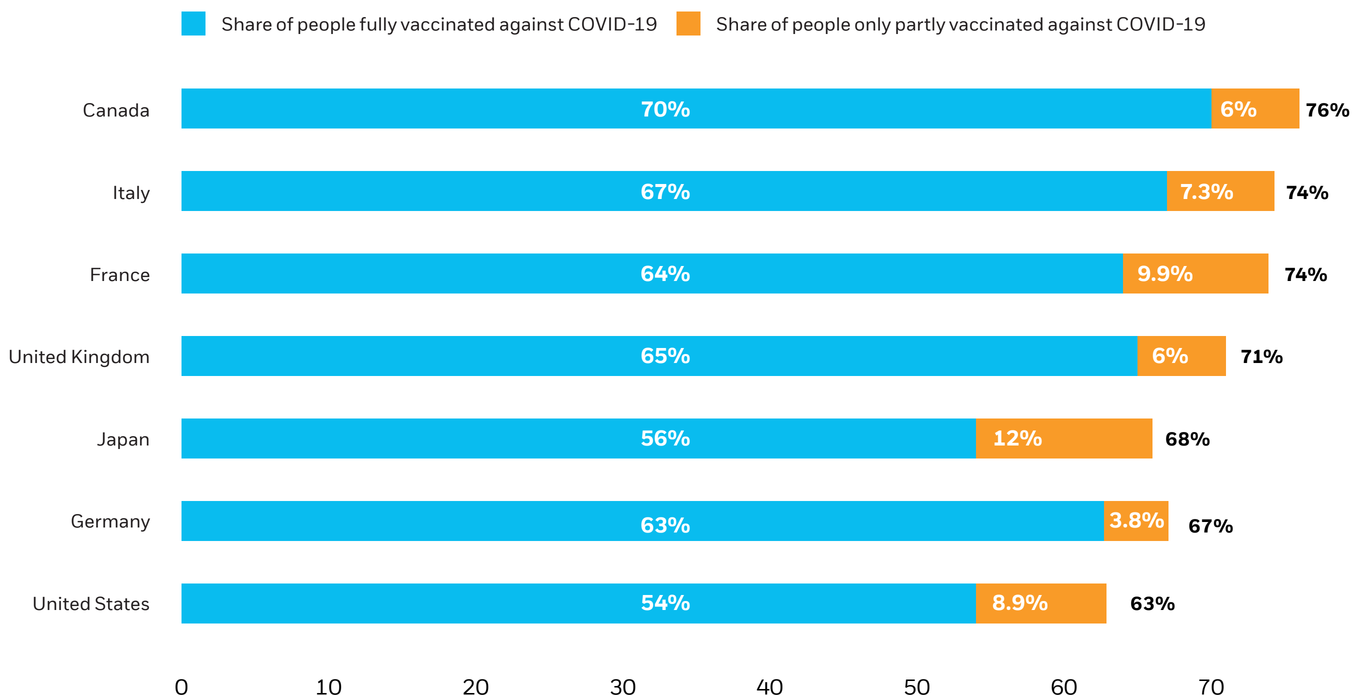
Figure 1: Share of people vaccinated against COVID-19



Data as of Sep 23, 2021. Source: Our World in Data.

Related RBC iShares ETFs:

- **XIC** iShares Core S&P/TSX Capped Composite Index ETF
- **XDIV** iShares Core MSCI Canadian Quality Dividend Index ETF
- **RCE** RBC Quant Canadian Equity Leaders ETF

U.S. equities Equities, earnings, and the economic restart

Key points

1. U.S. equity markets set new highs even as growth peaks.
2. Mid-cycle periods typically have seen positive equity returns among higher dispersion, arguing for selectivity within sectors.
3. Year-to-date flows remain strong into cyclical sectors but also point to investor hedging with defensive and quality exposures.

Macro waves

Peak growth may be behind us, but that has not derailed the U.S. equity market, which continues to set record highs even as we enter the mid-cycle phase of the economic cycle.

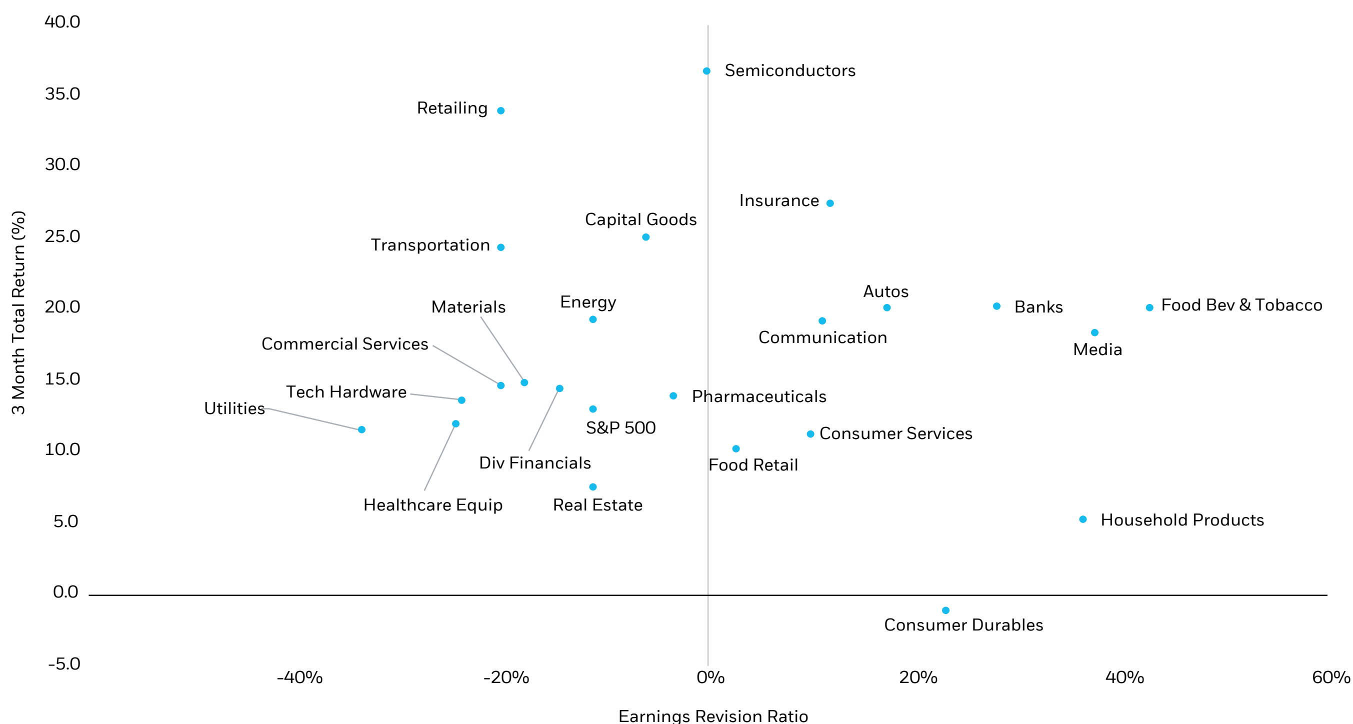
Data from both macroeconomic measures and corporate earnings metrics suggests that the highest rates of growth – driven both by the speed of the reopening and low base effects – likely occurred in the second quarter. Forecasted GDP growth is expected to fall by more than a percentage point in Q4, while consensus estimates place EPS (earnings per share) growth for the S&P 500 Index at "just" 17% in Q3 on a two-year growth basis versus 27% in Q2.[5]

Still, there are reasons for optimism. Real rates remain accommodative despite anticipation of a Fed taper, and waning fiscal support is still buttressed by the possibility of a bipartisan infrastructure bill. And, despite slowing from peak levels, expectations of growth remain well above potential over the next year.

While U.S. equities can provide - and in our analysis often have provided - positive returns in mid-cycle periods, there is a benefit in being selective, as dispersion amongst sectors and industries tends to rise when growth is positive but slowing (Figure 2). In these periods sectors with high profitability, low leverage, and strong pricing power have tended to outperform. And, if higher wage and price inflation persists in 2021, companies that can pass through prices and maintain profitability become more important than in the previous three decades of muted inflation.

From a sectoral vantage point, we identify a high concentration of quality companies in the technology sector, thanks to large cash holdings and strong balance sheets. We also spot opportunities within financials, particularly in regional banks, as the prospect for higher interest rates and steeper term structure may make these companies more profitable in the medium term. An allocation to healthcare can add defensiveness to a portfolio, while also standing to benefit from increased R&D spending in light of the pandemic.

Figure 2: Signs point to earnings peak and increased dispersion amongst U.S. sectors



Source: BlackRock, Refinitiv Datastream, chart by iShares Investment Strategy. As of September 1, 2021. The chart shows 3-month performance of the S&P 500 Index subsectors against their earnings revision ratios. Earnings revision ratio is calculated as the difference between number of upgrades and downgrades by analysts, divided by the total number of analyst estimates in the past three months. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

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Related RBC iShares ETFs:

XQQ iShares NASDAQ 100 Index ETF (CAD-Hedged)

XHC iShares Global Healthcare Index ETF (CAD-Hedged)

RUBH RBC U.S. Banks Yield (CAD Hedged) Index ETF

Flow and tell

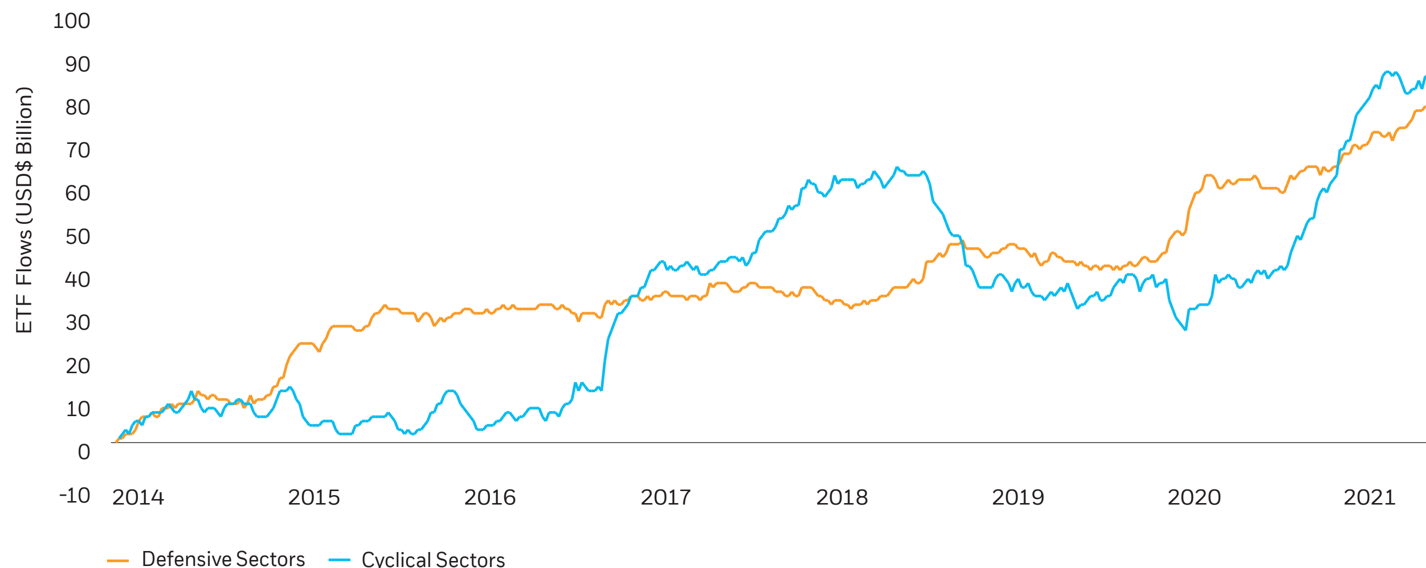
Investors have enthusiastically allocated to U.S. equities in 2021, reversing a more risk-off tone amid higher volatility last year. U.S. equity ETFs have captured 49% of total U.S.-listed ETF flows YTD, compared to just 35% in 2020.[6] The same has been true across all investor types and financial products with U.S. single stocks, mutual funds, ETFs and index futures all showing a surge in demand. Still, two dominant trends have emerged.

1. **Rapid reversals in market leadership have left investors with low style conviction.** The first quarter of the year was marked by a rash of inflows to cyclical exposures and the value factor, a trade which was tempered by a relentless rally in the rates market since March. Concerns that new variants would impact the global reopening drove flows away from cyclicals and towards defensive sector ETPs, with the former shedding $3.2 billion in July while the latter added $4.1 billion in new assets.[7] (Figure 3)

   Despite waning sentiment, August saw yet another reversal, this time back towards cyclicality following a strong Q2 earnings cycle. Cyclical sector ETPs posted net inflows of $5.1 billion during the month of August, driven in large part by year-to-date winners such as information technology and financial sector funds.[8] These reversals – between value/growth and cyclical/defensive exposures – have led investors to hedge their bets by allocating to both pro-cyclical value names and mid-cycle quality tilts, a barbell approach we continue to support.

2. **Investors have shown a clear preference for the ETF wrapper to express views.** While flows to all instruments have risen, those to ETFs have surged in the U.S. Just seven months into the year, flows to ETFs broke the previous annual record and may be on track for more than $1 trillion of new assets in 2021.

Figure 3: Barbelling – U.S.-listed ETF Flows to cyclical and defensive sectors, typically inversely correlated, have risen in tandem



Source: BlackRock, Markit, chart by iShares Investment Strategy. As of September 01, 2021.

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International equities: Quality over quantity: China's policy shift

Key points

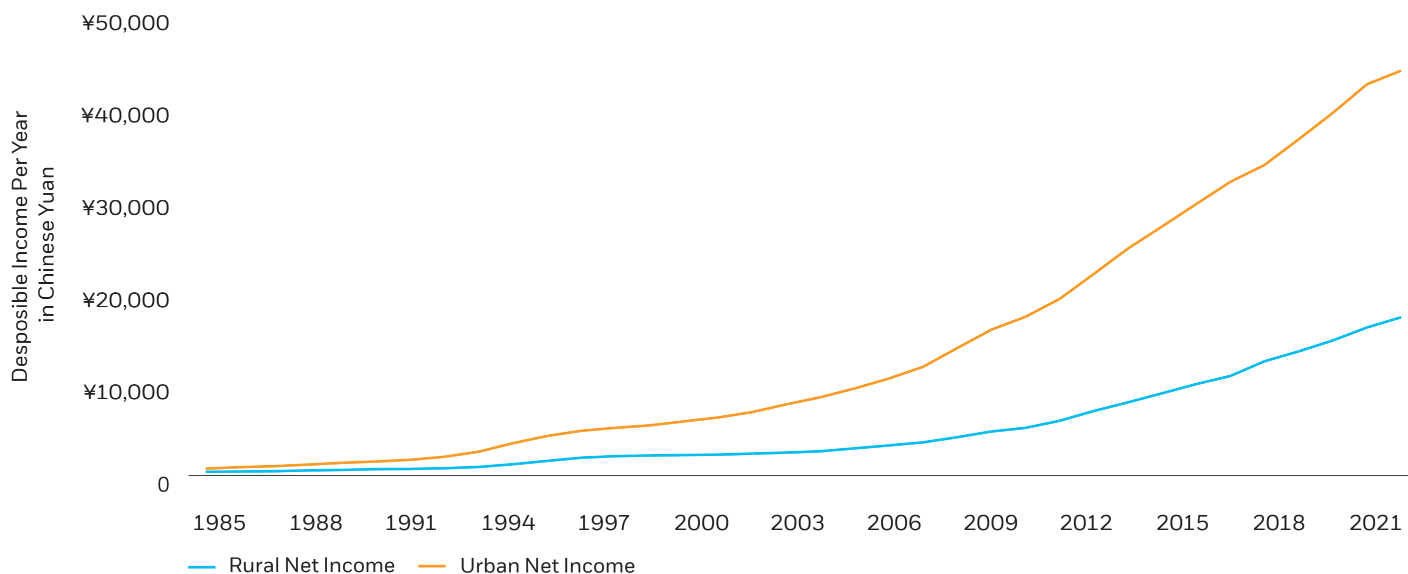
1. Many developed markets represent better tactical opportunities given higher vaccination rates and stronger economic recoveries.
2. China's recent regulatory crackdown rattled markets, but is likely to moderate, counterbalanced by a dovish shift in macro policy.
3. Investors are taking a longer-term view when investing in China and emerging markets.

Macro waves

Over the summer, China's regulatory tightening of private industries triggered selloffs in related exposures and dimmed investor sentiment around Chinese markets. We believe this will pass.

While policy uncertainty often leads to investor anxiety, it is important to view these policy changes in the context of China's reform agenda. Earlier this year, China set a modest economic growth target of 6% for 2021, as the country shifts its development focus from quantity to quality.[9] Regulatory tightening in sectors such as e-commerce, ride hailing, and after school tutoring has been implemented to address concerns about data privacy, inequality, and the rising costs of education, housing, and healthcare. (Figure 4)

Figure 4: A tale of two cityscapes: With rapid economic growth, Chinese inequality has also widened between urban and rural dwellers



Source: BlackRock, Refinitiv Datastream, chart by iShares Investment Strategy. As of September 01, 2021.

Therefore, we expect the regulatory clampdown to continue but its pace and intensity to moderate as policymakers weigh the impact on growth and financial markets. And while near-term regulatory risks may persist, the policy focus on quality may be beneficial to long-term growth. Erasing the burden of educational costs on young parents should support population growth in the long run while the anti-monopoly campaign creates a more favorable business environment for small enterprises.

Importantly, regulatory uncertainty is unlikely to structurally impair the strategic case for Chinese equities. For investors, the rising importance of China as well as the potential for a more bi-polar global economy supports the case for standalone positions in Chinese stocks alongside existing investments based on investment objectives.

Elsewhere, developed markets offer tactical opportunities given higher vaccination rates and stronger economic recoveries. European equities display attractive entry points to pursue cyclicality and value. In Japan, the resignation of Prime Minister Suga has focused attention on prospects for a new leader to implement more stimulus as the country prepares its own restart. This comes against a positive backdrop of broader vaccination, booming exports and upbeat corporate sentiment.

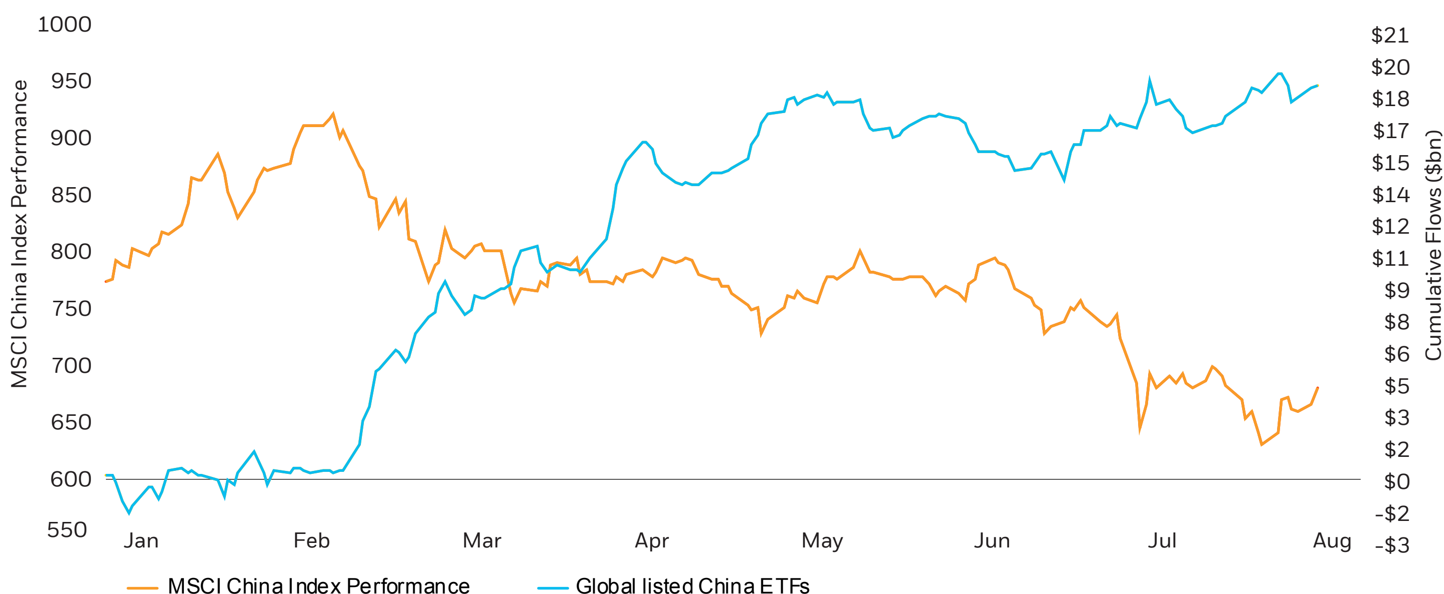
Related RBC iShares ETFs:

- **XCH** iShares China Index ETF
- **XEC** iShares Core MSCI Emerging Markets IMI Index ETF
- **XEU** iShares MSCI Europe IMI Index ETF
- **XEH** iShares MSCI Europe IMI Index ETF (CAD-Hedged)
- **XEF** iShares Core MSCI EAFE IMI Index ETF
- **XFH** iShares Core MSCI EAFE IMI Index ETF (CAD-Hedged)

Flow and tell

Despite underperformance and regulatory headwinds in Chinese equity markets, globally listed China focused ETF products have attracted more than $19 billion of inflows year to date (Figure 5). Since the regulatory crackdown on technology firms and education services, investors poured another $2 billion into globally listed China focused ETFs even as index levels declined, suggesting that investors are taking a longer-term view of the asset class. [10]

Figure 5: Lows and flows: Investors allocate to China ETFs in 2021 despite dropping index levels



Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. As of September 01, 2021. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transactions costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results. Index performance does not represent actual Fund performance.

Fixed income: Fixing Income: The new role of bonds in a balanced portfolio

Key points

1. Despite the recent moderation in the rates market, fundamentals point to moderately higher yields by year end, particularly at the back-end of the curve.
2. Investors should brace for inflation to moderate from current levels but remain higher than the pre-COVID range.
3. Within credit, fundamentals remain supportive for both investment grade and high yield, spreads remain quite tight limiting upside potential. We prefer high yield for its higher income potential, better valuations, and exposure to cyclical sectors on the back of a reopening world economy.

Macro waves

The low down on low rates

Since the beginning of the second quarter, Canadian government yields have moderated significantly relative to the speed of movement markets experienced in the beginning of the year. We view three key drivers of the stubborn, if unexpected, rally in bonds:

- Mounting fears around variant risk and its impact on global growth.
- Strong institutional demand for bonds at any price, particularly from pension funds whose stronger funded status has prompted de-risking into government bonds and high-quality corporate credit.
- Ample liquidity in the financial system, with over $1 trillion added to U.S. Treasury General Account (TGA) balances over the first half of 2021 alone.

Looking ahead, we believe the future path of interest rates will be more fundamentally driven, as technical factors like positioning and liquidity normalize. In particular, improving labour market data, rising inflation, fiscal stimulus, and the continued tapering of Canada's quantitative easing should drive back-end interest rates back to March levels.

Fixing the income conundrum

Against the backdrop of historically low yields (Figure 6) and the rising correlation of bond and equity markets, it's time to rethink the role of fixed income in a balanced portfolio. Below we explore three traditional functions as well as implementation solutions for current market conditions:

1. **Equity diversification**

   Traditional: As a ballast to the "riskier" parts of your portfolio, bonds can help provide protection in periods of equity market volatility, slowing growth or disinflation.

   Current: Faced with the potential for sustained higher inflation, we favor allocations to inflation-protected government bonds.

   - Investors benchmarked to the FTSE Canada Universe Bond Index can "disaggregate" and replace a portion of the index with inflation protected components.
   - A portion of the government bonds within the index can be replaced with short-dated U.S. TIPS or inflation-protected Canadian federal and provincial real return bonds (RRBs).

2. **Income**

   Traditional: Bonds are held for income generation via coupon payments.

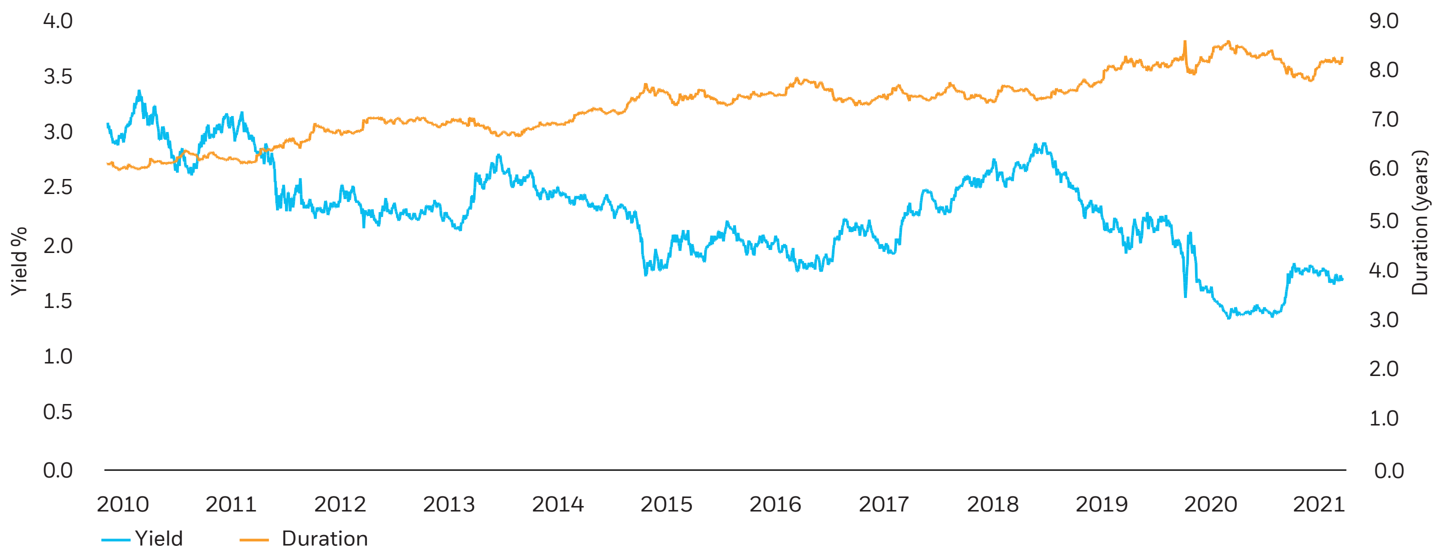
   Current: With over $15 trillion of global bonds generating negative yields, finding income in the current environment can be challenging.[11] We believe investors seeking income should prioritize quality cashflows within both the IG and HY spectrum of the market.

3. **Capital preservation**

Traditional: Bonds serve as a store of value within a portfolio.

Current: Given concerns around both inflation and duration risk, we prefer short duration credit exposures that provide some yield pickup relative to cash.

Figure 6: Less for more – The yield on the FTSE Canada Universe Bond Index has steadily fallen while interest rate risk has risen



Source: BlackRock , as of September 01, 2021. Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

Related RBC iShares ETFs:

Equity diversification

- **XRB** iShares Canadian Real Return Bond Index ETF
- **XSTH** iShares 0-5 Year TIPS Bond Index ETF (CAD-Hedged)

Income

- **XIG** iShares U.S. IG Corporate Bond Index ETF (CAD-Hedged)
- **XHY** iShares U.S. High Yield Bond Index ETF (CAD-Hedged)
- **XHB** iShares Canadian HYBrid Corporate Bond Index ETF

Capital preservation

- **XSB** iShares Core Canadian Short Term Bond Index ETF
- **XSH** iShares Core Canadian Short Term Corporate Bond Index ETF
- **XIGS** iShares 1-5 Year U.S. IG Corporate Bond Index ETF (CAD-Hedged)

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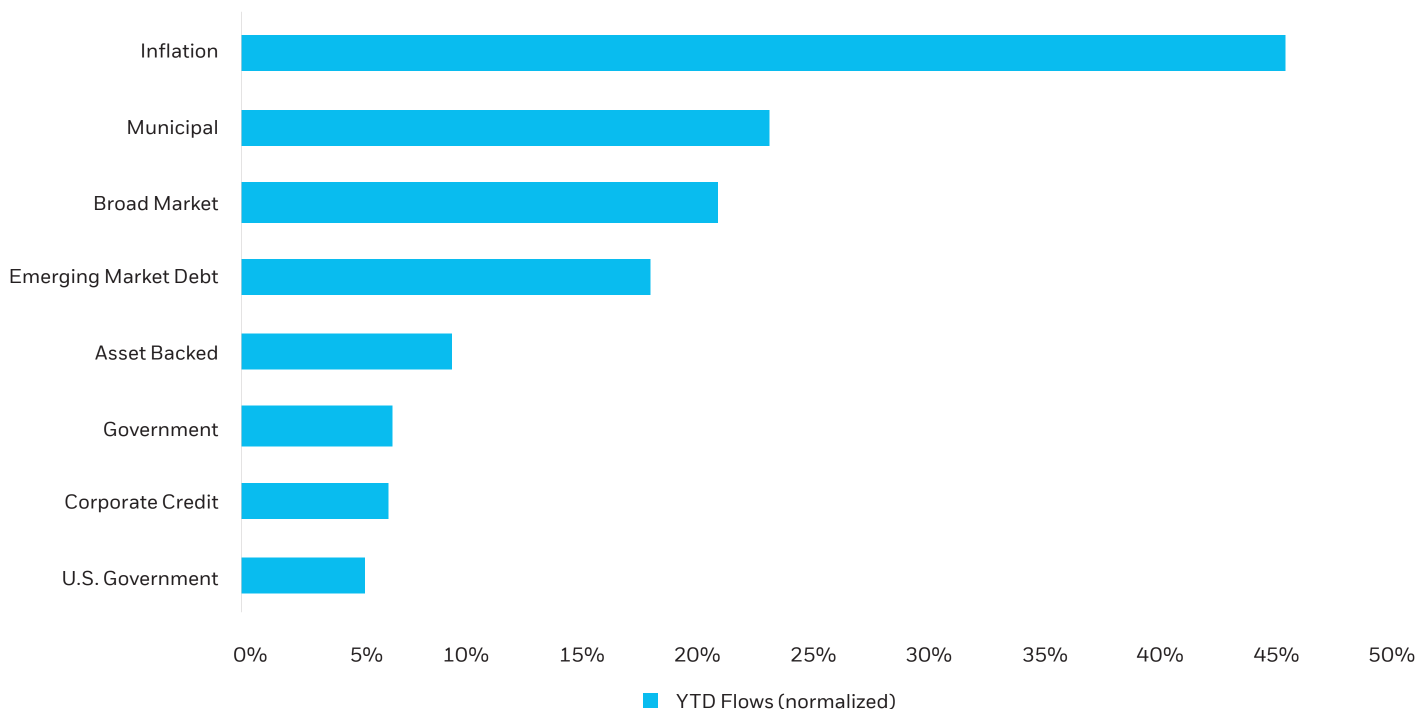
Flow and tell

Despite caution over rising rates and the lackluster performance of the asset class, flows into bond ETFs have remained steady throughout the year, with three themes emerging:

- Resiliency in rates: Counterintuitively, longer duration products have attracted inflows in both rising and stable rate environments. We believe technical factors like excess positioning and liquidity have been behind these flows. (Figure 7)
- Reflation roars: Inflation-linked ETFs have also been a large asset gatherer within the asset class as bonds linked to inflation, such as U.S. TIPS and Canadian RRBs, have outperformed their nominal counterparts by over 450-500 bps.[12]
- Broad credit funds have continued to gather flows as the need for income surpassed the fear of tightening spreads.

Figure 7: Fixed Income Sector ETP Flows YTD (Global-listed ETPs)



Source: Bloomberg, Blackrock; As of September 17, 2021.

Factor investing: Quality focus

Key points

1. Recent data points to U.S. growth peaking in the middle of this year.
2. In a mid-cycle environment of "peak growth," quality-oriented assets historically begin to benefit while value-oriented assets still perform due to above-trend growth.
3. U.S. listed ETF flows have begun to exhibit a quality bias, with inflows to the quality equity style factor, U.S. government bonds, and inflation-protected fixed income.

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Macro waves

You can only turn the lights back on once. Fiscal stimulus and easy monetary policy have provided a bridge through the pandemic, but as policy support fades, vaccination progress plateaus, and variant concerns mount, peak growth may be behind us. Indeed, U.S. real GDP growth this year appears to have peaked at 6.7% in the second quarter, with Bloomberg consensus estimates showing a slide to 5.0% in the third, 5.1% in the fourth, and 4.2% in the first quarter of 2022. (Figure 8)

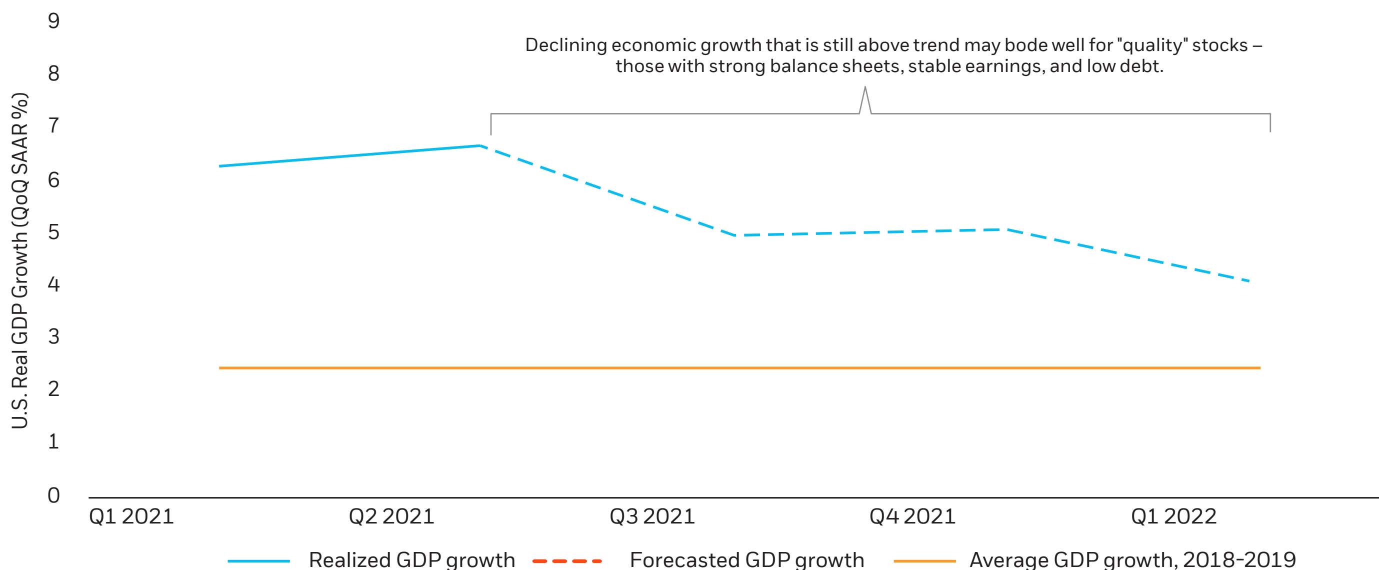
In our view, we are entering a mid-cycle environment where economic growth and activity flatlines or declines. Still-strong growth rates will continue to support cyclical, value-oriented companies, but financial markets are anticipatory, and we think that some of the early-cycle investment opportunities may have already played out, particularly in the U.S.

Looking past the peak, our historical analysis found that in a regime of high but declining growth, equity performance dispersion across industries increased, and industries with a quality tilt performed best. Moreover, quality industries exhibited a relatively lower correlation with economic growth, meaning that their price levels tend to react less to swings in activity data.

Our view that above-trend inflation will play out over quarters rather than months also adds to our conviction, as quality companies tend to have name brands with the pricing power needed to pass rising costs onto consumers.

As a result, we see a value-quality barbell strategy within equities as likely to offer greater risk-adjusted returns and offer a better hedge against possible slowdowns than a pure value allocation.

Figure 8: Positioning past the peak of U.S. growth



Source: BlackRock, Bloomberg, as of September 13, 2021.

Related RBC iShares ETFs:

- **XQLT** iShares MSCI USA Quality Factor Index ETF
- **XVLU** iShares MSCI USA Value Factor Index ETF
- **XDU** iShares Core MSCI US Quality Dividend Index ETF
- **XDUH** iShares Core MSCI US Quality Dividend Index ETF (CAD-Hedged)

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Flow and tell

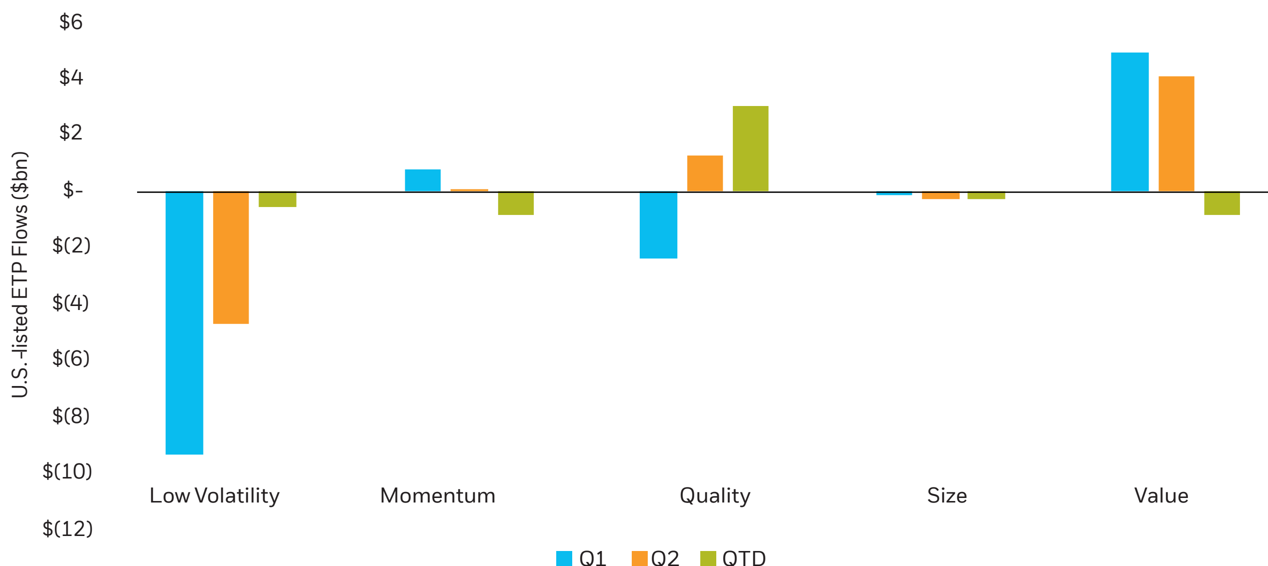
In the U.S., while value ETFs saw record-breaking inflows of $5 billion in Q1 and a further $4.1 billion in Q2, the pace slowed in Q3. Quality ETFs, in contrast, reversed a Q1 outflow by bringing in $1.3 billion in Q2 and $3.1 billion in Q3 as investors sought the relative safety of quality names in the face of persistent inflation and signs of slowing growth.[13] (Figure 9)

We have also seen a quality bias emerge within U.S. listed fixed income ETFs.

- Flows into U.S. government bonds turned positive in Q2, adding $5.3 billion after Q1 outflows of $1.2 billion.
- A resurgence in Q2 corporate credit inflows saw investment grade exposures take the lion's share of assets, taking in nearly double those of high yield ETPs.
- And, in Q1, $8.5 billion flowed into inflation-protected fixed income ETFs setting a new quarterly record, only to be beat by Q2 flows of $9.6 billion.

Sectoral flows paint a similar picture, with Q1 flow gatherers such as value-oriented financials, materials, and energy all seeing outflows in Q3 as rates moved lower over the summer. Meanwhile, healthcare and technology—both backbones of the quality factor—have enjoyed a resurgence, with greater inflows in Q3 than those seen in Q2, and after healthcare saw outflows in Q1.

Figure 9: A surge in flows to the quality factor



Source: Markit, Bloomberg, chart by iShares Investment Strategy. As of September 20, 2021.

Footnotes

1. Source: BlackRock Growth GPS, September 2021
2. Source: Statistics Canada
3. BoC Monetary Policy Report, July 2021
4. Source: MSCI Canada Index Factsheet, September 2021
5. Source: Bloomberg, as of September 01, 2021.
6. Source: Markit, as of September 01, 2021.
7. Source: Bloomberg, Markit, as of September 01, 2021.
8. Source: Bloomberg Markit, as of September 01, 2021
9. Source: the Rhodium Group, https://rhg.com/research/china-gdp-2021/, as of March 2021
10. Source: Markit, as of September 01, 2021.
11. Source: Bloomberg, as of September 01, 2021.
12. Source: Bloomberg, as of August 30, 2021; Bloomberg U.S. Treasury Inflation Protected Securities (TIPS) Index vs. Bloomberg U.S. Aggregate Bond index. Past performance does not guarantee future results.
13. Source: Markit, as of September 01, 2021.

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