Rick Rieder, Russ Brownback and Trevor Slaven contend that even as markets are gripped with the trauma of wild swings, and continued uncertainties, the seeds of future investment opportunity are being sown.

*Ripley’s Believe It or Not!* is an American franchise, founded by Robert Ripley, which deals in bizarre events and items so strange and unusual that readers might question the claims. Originally a newspaper panel, the *Believe It or Not* feature proved popular and was later adapted into a wide variety of formats, including radio, television, comic books, a chain of museums, and a book series. In our April 2 call with clients, we laid out an argument that contended that in March 2020 global investors experienced their own “believe it or not” moments, as a global pandemic of historic proportions led to cross-asset price action that was so drastic and volatile, it was truly hard to comprehend. We share those arguments below.

**Market moves that were hard to comprehend**

Indeed, the market moves last month were unlike any we have seen in our careers with many assets experiencing more year-to-date price volatility than what was realized over the entire previous decade. In early March, it became suddenly obvious that the COVID-19 crisis was going to morph into a contagious *whole-asset stack* shock, and very quickly thereafter virtually all global markets froze. Global risk assets were forced to be marked down to the price at which they could be indiscriminately liquidated. For assets that couldn’t find a clearing price, it was nearly impossible to discern their “actual value.” To wit, AAA rated assets were marked down by 10 or 20 points, in some cases. The fear was even more palpable in the markets for implied volatility where the cost of options approached the ten-year 100th percentile in nearly every asset class where options markets exist, while the CBOE’s VIX index hit an all-time high.

In the U.S., equities witnessed their third worst month in modern history, while U.S. high yield bond yields doubled in a two-week interval. Astoundingly, even the “risk-free” U.S. Treasury market was upset. While benchmark Treasury issues were sprinting toward the zero-lower bound, off-the-run Treasury issues couldn’t find clearing levels in the secondary markets, as there was simply no spare systemic balance sheet capacity. Global investors began hoarding cash in record-setting amounts, with money market funds receiving $500 billion of capital inflows over a four-week span. To be sure, the entire financial economy has been inundated with a true 100-year storm.

This financial panic reflected the unfolding left-tail scenario for the global economy that appears to be an unprecedented halt on a great deal of economic activity. We expect the real-time indicators to translate into stunningly poor (albeit lagged) economic data points in the coming weeks (see graph). Only a month removed from the end of a long and persistent string of full-employment readings, we suddenly face the highest jobless claims numbers in history. Moreover, the U.S. unemployment rate might exceed the 2008 high, and GDP will likely contract roughly 5% this year, the worst growth since the Great Depression. Fortunately, there is sufficient reason to view this growth shock as temporary.
Three years of crisis in comparison: 2001, 2008 and 2020

We find it useful to compare the looming growth shock to the two most recent U.S. recessions as we endeavor to visualize the trajectory of the eventual recovery. In the 2001 recession, aggregate personal income never contracted. Meanwhile, government benefits grew more than 25%, providing a $432 billion backstop such that throughout the recession, personal consumption never contracted. The 2008 recession was much deeper than 2001. Personal income fell 4%, or $650 billion, with financial asset income down -18%, or $505 billion. Somewhat offsetting that were government benefits that grew by roughly 33%, providing a $640 billion backstop. But even in the face of this significant income shortfall, personal consumption only contracted by 3% in 2008.

So how much household income will be lost as a result of the current crisis? We looked at 15 crucial sectors that make up roughly 70% of total private sector jobs. Depending on the specific sector we assumed anywhere from 30% to 90% of jobs will be impacted for a duration of between four weeks to six months. Based on our conservative assumptions, we’re forecasting that roughly 50 million workers will miss an average of 11 weeks of work, for a total lost income of nearly $460 billion. Fortunately, the recently signed $2 trillion CARES Act providing $525 billion of direct household income support should be able to keep aggregate U.S. personal income steady, ultimately supporting consumption on the other side of today’s necessary quarantining.

More broadly, there is little doubt that without the massive, holistic global policy response that we’ve already witnessed, some far worse real economy outcomes risked becoming deeply entrenched. Global policy makers have been bold and timely in both their fiscal and monetary policy responses, so much so that we see a right-tail scenario brewing for the financial economy in the quarters ahead. Indeed, in February and March alone, global fiscal and monetary policy responses totaled a staggering 11% of global GDP, and it’s highly likely that there’s more policy assistance on the way.

The historic marriage of fiscal and monetary policy measures

With respect to U.S. fiscal policy, we are convinced that the potency of the CARES Act is being systematically underestimated by conventional wisdom. Nearly all of the targeted categories of the legislation have impressive multipliers associated with them. The healthcare, research and development, infrastructure, and direct transfers to household segments all have multipliers that approach two, by some estimates, while the state and local aid, refundable rebates, and payroll tax holiday initiatives all have projected multipliers of nearly 1.5x. Contrast that to the 2017 tax reform act, which is thought to have had almost no multiplier at all, perhaps somewhere around 0.3x. Making some very conservative assumptions about the pace at which this committed fiscal outlay will be recycled over coming weeks/months, we see at least $1 trillion in spending over the next 90 days – that’s an annual run-rate of more than 20% of U.S. GDP, which is staggering and unprecedented, and will go a long way towards dampening the growth shock.

As far as the Fed is concerned, we’re convinced that its policy response was truly historic, wholly debunking the incorrect notion that their policy toolkit is finite. Again, using conservative estimates on how the Fed will proceed with planned asset purchases and funding programs, we see the Fed’s balance sheet growing by nearly $6 trillion before the end of Q3, an eye-popping number considering that the total size of their balance sheet was near $3.8 trillion as recently as last
September. In fact, the Fed will likely end up purchasing the equivalent of 20% of the U.S. Aggregate index over just a six-month window. This initiative will undoubtedly offer meaningful support for the entire domestic asset stack, save for entities with true existential concerns.

Moreover, when you add in the committed contributions from other global central banks, the resulting surge in global liquidity is profound (see second graph). We estimate that by year-end 2020, global liquidity will exceed 40% of global GDP, shattering the previous record and providing critical support for a nervous and heretofore fragile financial economy stunned by the crisis. In short, we think that absent some new shock, the holistic global policy response has likely been sufficient to provide support for most asset markets as the virus evolution unfolds in earnest.

Portfolio construction and asset allocation in a time of crisis

So, where does that leave us with respect to portfolio construction? For starters, developed market (DM) yields will stay stubbornly low as central banks will strive to keep both short rates (policy rates) and long rates, via quantitative easing (QE), very low for the foreseeable future. Aggressive central bank purchase programs will create a negative net fixed-income issuance paradigm of unprecedented scale providing a strong technical backdrop. Incredible fundamental dispersion will unfold as the varied fortunes of real economy actors become evident over coming weeks, leaving a fertile opportunity set across spread sectors.

The potential to construct a 4% to 5% yielding portfolio is now significantly more attractive than at the beginning of the year as we can get those yields with an even higher quality mix of assets today. Moreover, with many of those assets trading at nice discounts to par, there is also the potential for near-term capital appreciation.

As far as equities are concerned, it is critical to remember that each investment is simply a purchase of future cash flows. Clearly, 2020 earnings expectations have changed dramatically, but companies shouldn’t be valued based only on a single year’s earnings. Investors should be modeling at least the next several years of cash flows to come up with expected returns and then derive reasonable fair value. While 2020 EPS is likely to be down between 15% to 25%, at current prices near 2,500, the S&P is offering investors a nearly 7% annual risk premium, versus just half that level coming into the year. Even on depressed earnings estimates, discounting these cash flows with a normalized risk premium of 3.5% and today’s 1.0% risk-free rates would imply the S&P near 3,500 over the next year or two. If earnings recover more quickly, or the contraction is less severe, the rebound can be sharp. Compelling long-term value is clearly forming in U.S. equities.

So, we are thinking about the coming weeks in terms of two intervals. Initially, we plan on keeping a significant cash cushion given uncertainty as to the length and depth of the economic downturn. At the same time, we will follow the Fed and other DM central banks by purchasing what they’re purchasing, and assets that rhyme with those. That means buying U.S. nominal duration where there is still scope for rates to rally further (i.e. the back end), which also provides a
dependable risk hedge. We will own some U.S. breakevens that are cheap for technical reasons, and we will be selling
U.S. rate volatility as rates come down and are pinned lower, especially at the front-end.

We like rotating out of Agency mortgage-backed securities and into investment-grade credit and buying other high-quality
assets that are not included in Fed purchase programs. Finally, we want to pick away at some sectors of the equity market
that have had valuations destroyed beyond even worst-case scenarios, such as healthcare, biotech, technology, defense,
home builders, and others. We’ll target moderate equity exposures but can take on more exposure through selling volatility
that would put us into long positions at lower levels and thereby benefit from still crazy-expensive implied volatility.

Longer term, we envision getting more invested, allowing cash to run down. We will rotate down the credit spectrum,
swapping investment-grade credit for higher quality high-yield or loans. We’ll cautiously grow EM exposure, though EM
fundamentals remain a ‘known unknown’ in terms of the crisis evolution. We anticipate that we’ll want to reduce some of
the long-end duration positions in DM rates and high-quality assets, eventually as greater fundamental visibility emerges,
and high-quality assets rally through fair value. Finally, we also plan on growing the equity exposure, this time in outright
expressions as well as through buying options that will likely have cheapened considerably. While the magnitude of this
unfolding crisis is truly historic, eventually things will return to a more normal equilibrium, and as is often the case, the
markets will lead the way back to normalcy, believe it or not!

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