Weekly commentary

BlackRock

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2022's big change: Fed hikes rates




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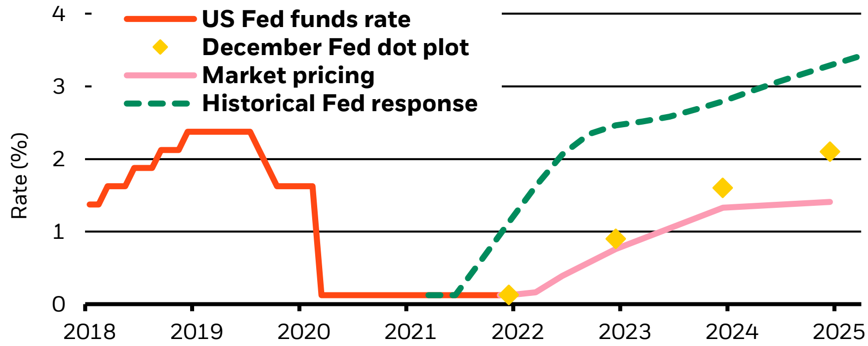
- The Federal Reserve will join other central banks in raising rates for the first time since the pandemic began. We expect a historically muted response to inflation.
- Stocks posted solid gains and bonds fell in 2021 – a pattern seen only in a few years since 1977. We see a repeat in 2022, albeit with moderating equity returns.
- U.S. employment data are in focus this week as they play into the timing and path of the Fed's rate hikes. PMI data will give a read on the restart's momentum.

Last year saw central banks living with inflation. This higher tolerance for price pressures, and the powerful economic restart, kept risk assets buoyant and limited the rise in yields. How central banks - particularly the Fed - respond to inflation will be the key story for 2022, in our view. We expect the Fed to raise rates but see its cumulative response to inflation as more muted than ever before. Yet the possibility that policymakers or investors misread the situation prompts us to trim risk.

A historically muted response

Fed funds rate vs. historical response and expectations, 2018-2025



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Bloomberg, December 2021. Notes:: The chart shows the U.S. nominal federal funds rate (orange line), the projected path implied by the dot plot in the U.S. Federal Reserve's latest Summary of Economic projections (yellow diamonds) and the path implied by market pricing. The green dotted line shows the path that would have been implied by a monetary policy rule linking the choice of policy rate to the rate of inflation and the level of the output gap.

2021's powerful restart of economic activity resulted in severe price pressures and supply bottlenecks. In a stark departure from past practice of pre-emptive tightening, most developed market (DM) central banks did not respond when inflation and growth surged. Nominal bond yields rose, but not as much as inflation. This kept real yields deeply negative and supported equities, the hallmarks of our 2021 *new nominal* investment theme. The next phase of this story is playing out now. Most central banks are poised to nudge up policy rates – but this is taking the foot off the monetary accelerator, not hitting the brakes. We don't see them responding aggressively to persistent inflation. Case in point: the Fed. It signaled three rate increases this year at its December meeting, noting high inflation, strong growth and labor market improvements. This is more than we expected, but what matters is the sum total of rate hikes. The Fed's indicated policy response (yellow dots in the chart) is very mild compared with how it would deal with inflation in the past: a series of rapid-fire rate hikes that would have already began and would hoist the fed funds rate to near 4% over time (dotted green line).

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In developed economies, we see the European Central Bank (ECB) keeping its foot on the accelerator while others such as the Fed prepare to pull back slightly. Importantly, no one is contemplating hitting the brakes – a factor for our modestly pro-equities stance and upgrade to U.S. equities. What matters next is whether DM central banks think their respective labor markets have returned to pre-Covid trends. Why? They may have an explicit employment mandate, like the Fed, or they use labor market conditions as a gauge for future inflationary pressures. This will play into the timing, pace and end point of policy hikes.

As we note in our 2022 Global Outlook, a unique confluence of events – the restart, new virus strains, supply-driven inflation and new central bank frameworks – are creating confusion as there are no historical parallels. Cutting through this confusion is key which is why we assess alternative scenarios to our base outcome and trim risk.

What are the risks to our base case? One is a delayed activity restart due to a global resurgence in Covid-19 infections. This could be particularly acute in China if its zero-Covid approach results in repeated activity shutdowns. We expect the People's Bank of China to keep policy looser as a result, a shift already underway after last year's economic slowdown.

We see two other risks, both negative for risk assets and fixed income. Central banks could revert to previous policy responses in the face of persistent inflation pressures. The Bank of England (BoE) – which in December became the first major DM central bank to raise rates since the pandemic struck – has made the most noise about responding more aggressively to inflation, leading markets to expect repeated rate hikes. The BoE may serve as a test case of a DM central bank coming closer to hitting the brakes, prompting the market to price in a risk of a policy reversal on rates by 2024. And inflation expectations could become unanchored from policy targets in the post-Covid confusion, forcing central banks to react aggressively. This could lead to stagflation: higher inflation becoming sticky amid stagnating activity. Understanding these potential outcomes around inflation and the market implications is key to *cutting through confusion* outlook theme.

Our bottom line: We expect interest rates to end at a lower level than in the past given higher inflation. That matters more for markets than what rates are going to do next year, in our view. We see the higher inflation regime and solid growth as positive for risk assets but bad for bonds for a second consecutive year – the new regime highlighted in our 2022 outlook.

Market backdrop

Global stocks ended 2021 up 19% while global fixed income fell 5%. We expect a repeat of this unusual combination in 2022, albeit with more moderate equity returns. The reason is the historically muted policy and market response to inflation. The Fed confirmed this at its meeting last month. This should keep real yields negative and support equities. We see inflation settling at a level higher than pre-Covid even as pressures from supply bottlenecks ease.

Assets in review

Selected asset performance, 2021 year-to-date and range

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Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Dec. 31, 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, ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, spot gold, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

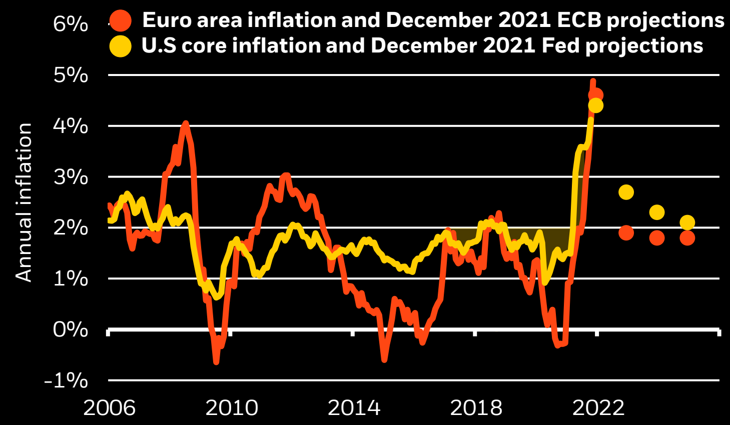
Macro insights

Inflation has jumped across major economies, largely driven by supply and demand mismatches as economies restart following pandemic-induced shutdowns. The Fed and the ECB both have an inflation target of 2% - and both are ostensibly exceeding it by quite some way, at least for now. See the chart.

It's not today's inflation rate that matter to these central banks, however. For the Fed, it's what it sees as the average inflation rate. For the ECB, it's the inflation rate it projects over the medium term. By these metrics, only the Fed has met - and exceeded - its inflation goal. U.S. core PCE now averages 2.2% over the past five years, and this could rise further as the Fed is forecasting inflation to stay above 2% at least until 2024. The ECB is forecasting inflation to drop below its target within around a year and stay there. This is why the Fed is set to start raising interest rates next year, whereas we see the ECB keeping rates on hold in 2022 and beyond and unlike other major central banks is still providing monetary support. See our macro insights hub.

Where's inflation headed?

U.S. and euro area inflation and forecasts, 2006-2024



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Eurostat, Federal Reserve, ECB, with data from Haver Analytics, December 2021. Note: The chart lines show U.S. core PCE inflation and euro area headline inflation. The dots show forecasts published in the U.S. Summary of Economic Projections and ECB/Eurosystem staff forecasts.

Investment themes

1 Living with inflation

- We expect inflation to be persistent and settle above pre-Covid levels. We expect central banks to kick off rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.
- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve next year.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation, even as the Fed has started to warn of inflation risks.
- Other DM central banks have signaled policy rate paths with steeper initial increases, and many of their emerging market (EM) counterparts have already lifted off.
- The Fed doubled the tapering of its bond purchases $30 billion a month to finish earlier this year. The central bank has achieved its new inflation goal to make up for past misses; the Fed now sees full employment being reached, justifying the start of rate hikes.
- The Fed's projected rate hikes in 2022 are quicker than we expected, but the total amount of hikes is unchanged and muted – keeping with our *new* nominal theme. We see risks to both the upside and downside of the Fed's rate projections.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- A unique mix of events - the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks - could cause markets and policymakers to misread the current surge in inflation.
- We keep the big picture in mind: We see the restart rolling on, inflation meeting a muted central bank response, and real rates remaining historically low.
- We do see increasing risks around this base case: Central banks could revert to their old policy response, and growth could surprise on the upside or disappoint.
- There's also a risk markets misread China's policy. The country has emphasized social objectives and quality growth over quantity in regulatory crackdowns that have spooked some investors. Yet policymakers can no longer ignore the growth slowdown, and we expect incremental loosening across three pillars - monetary, fiscal and regulatory.
- **Investment implication:** We have trimmed risk-taking amid an unusually wide range of outcomes.

3 Navigating net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today. The net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor sectors with clear transition plans. Over a strategic horizon, we like the sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication**: We favor DM equities over EM as we see them as better positioned in the green transition.

Week ahead

Jan. 5	Germany, euro area, U.S. PMIs
Jan. 6	Japan CPI and services PMI, Germany industrial orders, U.S. jobless claims
Jan. 7	U.S. non-farm payrolls; China trade data ; Euro area inflation

U.S. employment data will be the key indicator for assessing whether the Fed follows through with its planned rate increases in 2022. A series of Purchasing Managers' Indexes should give investors a read on the momentum of the restart. China's trade data will give an indication of whether supply bottlenecks that have pushed up inflation are resolving.

Directional views

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

Underweight **Neutral** **Overweight**

Change in view
Previous New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight on equities on a strategic horizon. We see the combination of low real rates, strong growth and reasonable valuations as favourable for the asset class. 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 indices. Tactically, we are overweight equities amid solid economic fundamentals and historically low real rates.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich, and we prefer to take risk in equities instead. On a tactical horizon, we are neutral credit given low spreads across sectors and prefer EM local markets to high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Within the underweight on nominal DM government bonds, we prefer shorter-dated over long-dated maturities. Rising debt levels may eventually pose risks to the low rate regime. We prefer inflation-linked bonds. Tactically, we keep our significant U.S. Treasuries underweight on expectations of rising yields into the Fed's taper and rate kick-off. We prefer inflation-linked bonds for interest rate exposure and as a portfolio diversifier.
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 and not suitable for all investors.

Note: Views are from a U.S. dollar perspective, December 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

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, December 2021

Underweight | Neutral | Overweight

Change in view: Previous → New

	Asset	Underweight	Overweight	
Equities	**Developed markets**		■	We are overweight developed market equities. We see still solid growth and low real yields supporting valuations. We prefer to diversify our exposure.
Equities	United States		■	We are overweight U.S. equities on still strong earnings momentum. We do not see gradual policy normalization posing significant headwinds.
Equities	Europe		■	We stay modestly overweight European equities given attractive valuations. We believe the rise in Covid infections may stall but not derail the restart
Equities	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
Equities	Japan			We have a small overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
Equities	**China**		■	We stay moderately positive on Chinese equities as we see a shift to a slightly easier policy. We expect the regulatory clampdown to last but not intensify.
Equities	**Emerging markets**			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
Fixed Income	U.S. Treasuries	■■		We are underweight U.S. Treasuries primarily on economic fundamentals and valuations. We see risks tilted toward higher yields into the Fed taper and subsequent lift-off.
Fixed Income	Treasury Inflation-Protected Securities		■	We stay overweight U.S. TIPS as we expect inflation to be persistent and settle at a higher level than pre-Covid. We prefer TIPS for interest rate exposure and diversifiers.
Fixed Income	European government bonds	■		We turn underweight European government bonds. We see yields heading higher. Current market pricing points to no substantive change in monetary policy for several years.
Fixed Income	UK gilts			We are neutral UK Gilts. We see UK policy rates rising before DM peers, yet believe market expectations of the subsequent pace are overdone amid constrained supply.
Fixed Income	China government bonds		■	We are overweight Chinese government bonds. Potentially easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
Fixed Income	Global investment grade	■		We stay underweight investment grade credit. We see little room for further yield spread compression and remain concerned about interest rate risk.
Fixed Income	Global high yield			We are neutral high yield. We do not see compression in high yield spreads yet still find the carry attractive. We prefer to take risk in equities.
Fixed Income	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.
Fixed Income	Emerging market – local currency		■	We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view.
Fixed Income	Asia fixed income		■	We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income and carry.

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