Weekly commentary

BlackRock

May 9, 2022

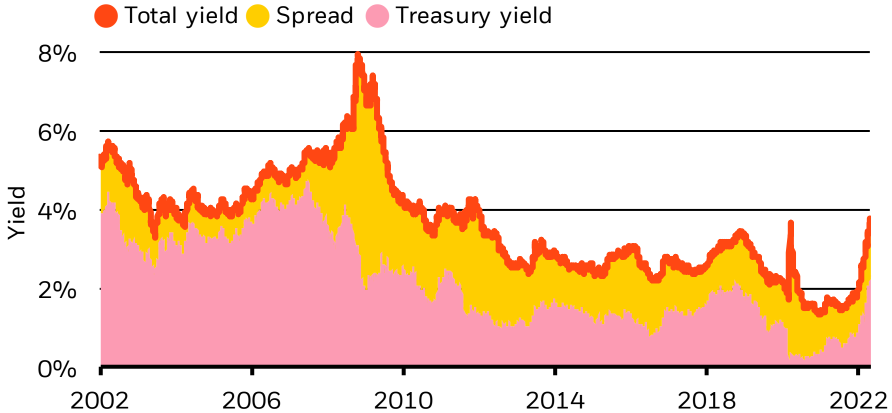
A rebalancing act to reduce risk

- We slightly reduce risk on a worsening macro outlook. We upgrade European government bonds and investment grade credit, and downgrade Chinese assets.
- The Fed raised rates by 0.5% last week – the largest increase since 2000 – and signaled similar rises ahead. Long-term yields shot up and stocks gyrated.
- Data this week may show increasing U.S. core inflation on likely higher services and housing costs. We see inflation settling at a higher level than pre-Covid.

We nudge down risk on a worsening macro outlook: the commodities price shock and a growth slowdown in China. We also see little chance of a perfect economic scenario of low inflation and growth humming along. Last week's market rout shows investors are adjusting to this reality. We upgrade investment grade (IG) credit and European government bonds to neutral as we see opportunities there. We downgrade Chinese assets and Asia fixed income as we consider them riskier now.

Yield on offer

Global investment grade corporate yield, 2002-2022



Sources: BlackRock Investment Institute with data from Refinitiv Datastream and Bloomberg, May 2022. Notes: The chart shows the yield of the Bloomberg Global Aggregate–Corporate Index broken into option-adjusted spread (yellow) and corresponding Treasury yield (pink).

Bonds are generally not attractive in inflationary times, and we remain overall underweight the asset class. Yet this year's dramatic sell-off has restored some value in pockets of the market, in our view. First, we have warmed up to European government bonds because we believe market expectations of rate hikes by the European Central Bank (ECB) are too hawkish. We see the energy shock hitting Europe hard - and causing the ECB to move very slowly in normalizing policy. We also see the asset class as a buffer against the growth shock, after downgrading European equities in March. Second, we are seeing some value in IG credit as annual coupon income is nearing 4%. That's the highest in a decade, as the red line in the chart shows, driven by a rise in Treasury yields (the pink area in the chart) and a widening of spreads (yellow). Crucially, we remain underweight U.S. Treasuries. We see the yield curve steepening on further rises in long-term yields as investors want more compensation for holding long-term bonds amid inflation.

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The big picture: The Ukraine war, a global energy shock and the risk the Fed tries to fight the supply-driven inflation have sparked a reassessment of macro scenarios among market participants. The root cause is inflation in a world shaped by supply. It started with the supply shock from the restart of economic activity. Russia's invasion of Ukraine added a broad commodities price shock on top of that. The Fed and other central banks are facing a tough choice now: suppressing supply-driven inflation means raising rates so high that they destroy growth and jobs. We believe the Fed ultimately won't raise rates beyond neutral - a level that neither stimulates nor decreases economic activity – to avoid such a scenario. This means it will have to live with inflation that we see settling at a higher level than pre-Covid. We believe the eventual sum total of rate hikes will be historically low, given the level of inflation. This means we still favor equities over fixed income.

At the same time, we recognize risks have risen. The commodities price shock is set to hit growth, especially in Europe and emerging markets that are commodities importers. The Fed rightly is fast normalizing policy but could slam the brakes on the economy if it chooses to fight inflation. It's tough to see a perfect outcome. Getting inflation down to pre-Covid levels likely means recession, as the Bank of England warned last week. And the growth outlook for China, the world's second-largest economy, is quickly deteriorating amid widespread lockdowns in an attempt to halt the spread of Covid.

We are downgrading Chinese stocks and bonds to neutral on the deteriorating macro outlook. We see a growing geopolitical concern over Beijing's ties to Russia. This means foreign investors could face more pressure to avoid Chinese assets for regulatory or other reasons. We previously kept our modest overweight on Chinese assets because we saw improved valuations making up for the risks. The rapidly worsening outlook for China's growth on widespread lockdowns to curtail a COVID spike has changed this. Lockdowns are set to curtail economic activity. China's policymakers have heralded easing to prevent a growth slowdown – but have yet to fully act. And yields on Chinese government bonds have fallen below those on U.S. Treasuries amid policy divergence, eroding their previous appeal as a source of potential coupon income.

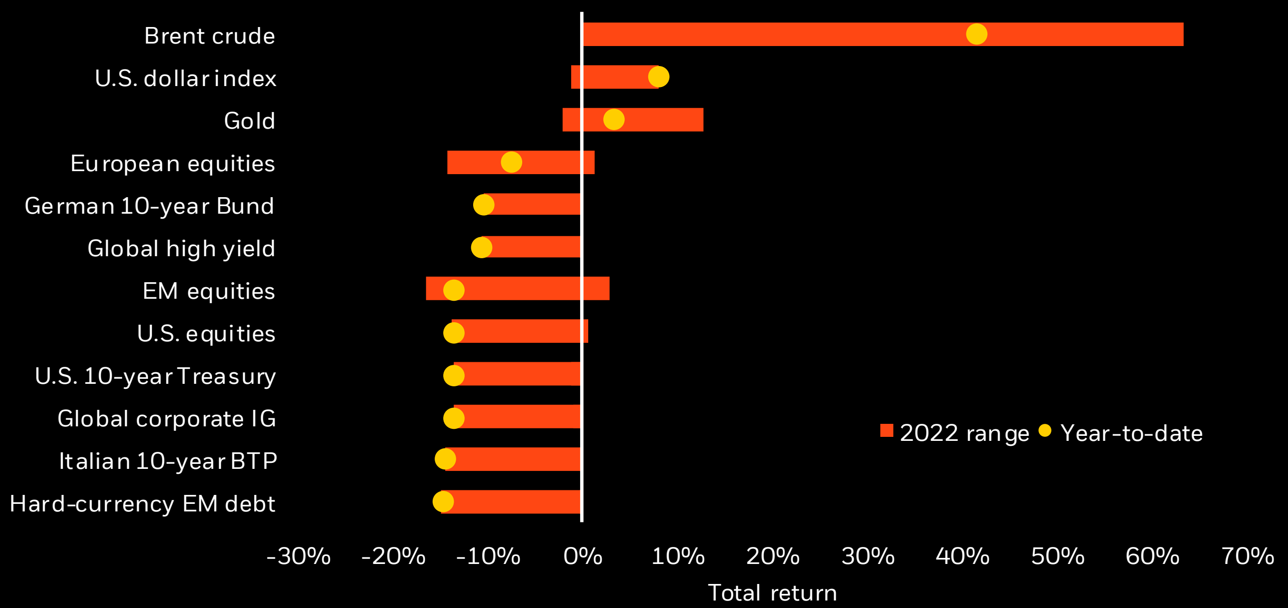
Bottom line: We are nudging down risk amid the commodities price shock, deteriorating growth in China and tough trade-offs for central banks. We upgrade European government bonds and IG credit to neutral as we see tactical opportunities there. We downgrade Chinese assets to neutral due to geopolitical concerns and a worsening macro outlook. Overall, we remain overweight equities, with a preference for U.S. and Japanese stocks, and underweight U.S. Treasuries.

Market backdrop

The Fed raised its policy rate by 0.5% last week and said it would start winding down its balance sheet by not re-investing the proceeds from maturing bonds. Chair Jerome Powell signaled 0.5% hikes at the next two meetings in an effort to rein in inflation, and dismissed larger increments for now. We believe the sum total of hikes will be historically low, but see long-term yields rising further as investors demand higher compensation for holding long-term bonds amid persistent inflation.

Assets in review

Selected asset performance, 2022 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of May 5, 2022. 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: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

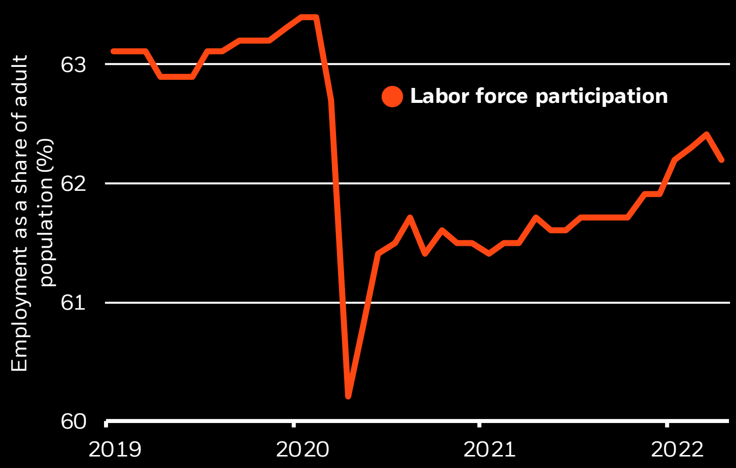
Macro insights

The U.S. unemployment rate is now down to 3.6%, almost the same as it was right before the pandemic struck. We don't think that means the labor market is fully healed yet. Why? Many have left the workforce for health, lifestyle or other reasons (the "Great Resignation"). U.S. labor force participation – the share of the working-age population with a job or actively looking for work – is 1 percentage point below its pre-pandemic level, as the chart shows. In Europe, furlough programs helped participation recover quickly.

How to solve for the reduced labor supply in the U.S.? Further wage growth could entice those who left the workforce during the pandemic to return. That means the number of working people can rise, without the unemployment rate dropping to unsustainable levels. Could higher wages spark higher inflation? Not necessarily. We find companies are paying less in labor costs per unit of output than before the pandemic thanks to higher productivity and prices. We believe wages can rise without adding to inflation – and help normalize the labor market. See more on this in our commentary from last week or visit our macro insights hub.

U.S. labor market still healing

U.S. labor force participation, 2019-2022



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Haver Analytics, May 2022. Note: The chart shows the share of the working-age population that is working or actively looking for work.

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. If they hike interest rates too much, they risk triggering a recession. If they tighten not enough, the risk becomes runaway inflation. It's tough to see a perfect outcome.
- The Fed has projected a large and rapid increase in rates over the next two years, and raised rates by 0.5% in May - the largest increase since 2000. We see the Fed delivering on its projected rate path this year but then pausing to evaluate the effects on growth.
- Normalization means that central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. The risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- The Bank of England of England warned of the poisonous combination of recession and high inflation as it raised interest rates to their highest level since 2009.
- The European Central Bank has also struck a hawkish tone, but we expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation.
- **Investment implication**: We prefer equities over fixed income and overweight inflation-linked bonds.

2 Cutting through confusion

- We had thought the 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 saw the confusion play out with the hawkish repricing in markets this year – and central banks have sometimes been inconsistent in their messages and economic projections, in our view.
- The Russia-Ukraine conflict has aggravated inflation pressures and has put central banks in a bind. Trying to contain inflation will be more costly to growth and employment, and they can't cushion the growth shock.
- We see a worsening macro outlook because of the commodities price shock and a growth slowdown in China.
- **Investment implication:** We have slightly reduced our risk exposure.

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.
- The West's decision to reduce reliance on Russian fossil fuels will encourage fossil fuel producers elsewhere to increase output, but we don't expect an overall increase in global supply and demand. We see the drive for greater energy security accelerating the transition in the medium term, especially in Europe.
- 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 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

May 9	China trade data	**May 11**	U.S. consumer prices; China consumer and producer prices
May 10	Germany ZEW survey; China credit and money data	**May 12**	UK GDP release

U.S. inflation data this week could point to increasing core inflation pressure amid higher services inflation and housing costs. Inflation broadly has been driven by supply factors: The shock from the war in Ukraine came on top of an existing supply shock from the restart of economic activity. We see supply-driven inflation settling at a higher-level than pre-Covid.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2022

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	+1	We increased our strategic equities overweight in the early 2022 selloff. We saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. 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 favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.
Credit	-1	Neutral	We are underweight credit on a strategic basis against a backdrop of rising interest rates. We prefer to take risk in equities instead. Tactically, we have upgraded credit to neutral as the dramatic sell-off this year has restored value in areas such as investment grade. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk, in our view.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio diversifiers with yields near lower bounds. We see investors demanding higher compensation for holding government bonds amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we also underweight government bonds as we see the direction of travel for long-term yields as higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers in the higher inflation regime.
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. 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, May 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	+2	We overweight DM stocks amid supportive fundamentals, robust earnings and low real yields. We see many DM companies well positioned in the inflationary backdrop thanks to pricing power. We prefer the U.S. and Japan over Europe.
United States	+2	We overweight U.S. equities due to still strong earnings momentum. We see the Fed not fully delivering on its hawkish rate projections. We like the market's quality factor for its resiliency to a broad range of economic scenarios.
Europe	+1	We are moderately overweight European equities as we expect the energy shock to hit European growth hard. We like the market's cyclical bend in the inflationary backdrop and expect the ECB to only slowly normalize policy.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued and prefer other DM equities such as U.S. and Japanese stocks.
Japan	+2	We are overweight Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.
China	Neutral	We cut our modest overweight to Chinese equities to neutral on a worsening macro outlook. China's ties to Russia also have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities and prefer DM equities, given more challenged restart dynamics, higher inflation pressures and tighter policies in EM.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's deteriorating macro outlook is a worry, and policymakers have yet to fully deliver on promises of easing.
U.S. Treasuries	-1	We underweight U.S. Treasuries even as yields have surged this year. We see long-term yields move up further as investors demand a higher premium for holding governments bonds. We prefer short-maturity bonds instead.
Treasury Inflation-Protected Securities	+1	We overweight U.S. TIPS as we see inflation as persistent and settling above pre-Covid levels. We prefer TIPS as diversifiers in the inflationary backdrop.
European government bonds	Neutral	We upgrade European government bonds to neutral. Market pricing of euro area rate hikes is too hawkish, we think, given the energy shock's hit to growth.
UK gilts	Neutral	We are neutral UK Gilts. We see market expectations of rate hikes as overdone amid constrained supply and weakening growth.
China government bonds	Neutral	We cut Chinese government bonds to neutral. Policymakers have yet to take easing actions to avoid a slowdown, and yields have fallen below U.S. Treasuries.
Global investment grade	Neutral	We upgrade investment grade credit to neutral as this year's sell-off has made valuations more attractive. Coupon income is the highest in about a decade.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive. We prefer to take risk in equities.
Emerging market – hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market – local currency	+1	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, and offer compensation for interest rate risk.
Asia fixed income	Neutral	We downgrade Asia fixed income to neutral. A worsening macro outlook and geopolitical concern about China's Russia ties make Chinese assets riskier, in our view. Outside China, we like Asian sovereigns and credit for income.

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