

Weekly commentary

June 13, 2022

BlackRock

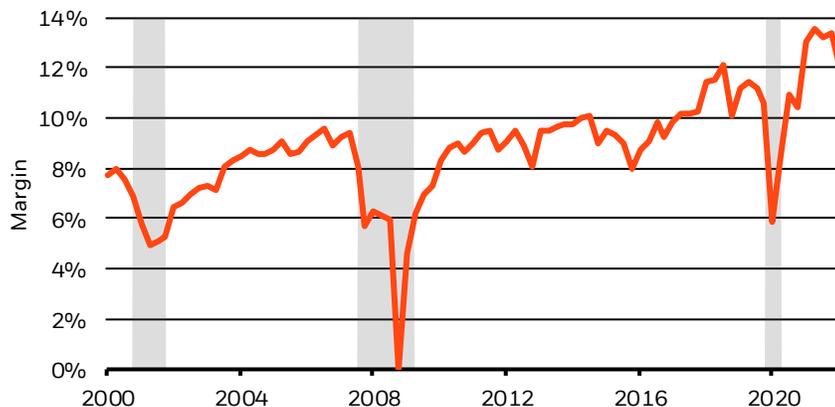
Why we're not buying the dip in stocks

- We're not buying the stock dip because valuations haven't really improved, there's a risk of Fed overtightening, and profit margin pressures are mounting.
- Stocks fell and yields jumped last week on news of persistent U.S. inflation and rapid euro area rate hikes, showing markets are primed to be hawkish on rates.
- The Fed is set to lift rates by 0.5% this week. The eventual sum total of rate hikes will be historically low, in our view, but the risk of overtightening is rising.

U.S. stocks have suffered the biggest year-to-date losses since at least the 1960s. That's ignited calls to "buy the dip." We pass, for now. Valuations aren't much cheaper given rising interest rates and a weaker earnings outlook, in our view. A higher path of policy rates justifies lower equity prices. We also see a risk the Fed will lift rates too high – or that markets believe it will. Plus, margin pressures are a risk to earnings. That's why we're neutral on stocks on a six- to 12-month horizon.

Margin pressure worries mount

S&P 500 operating margin, 2000-2022



Sources: S&P, with data as of March 31, 2022, and BlackRock Investment Institute, June 2022. Notes: The chart shows operating margins for S&P 500 companies.

So we don't buy the dip. Why? Three reasons. First, profit margins have marched upward for two decades, as the chart shows. We now see increasing risks to the downside. We expect the energy crunch to hit growth and higher labor costs to eat into profits. The problem: Consensus earnings estimates don't appear to reflect this. For example, analysts expect S&P 500 companies to increase profits by 10.5% this year, Refinitiv data show. That's way too optimistic, in our view. Stocks could slide further if margin pressures increase. Falling costs like labor have fed the multi-decade profit expansion. So far, unit labor costs – the wages a company pays to produce a unit of output relative to its selling price – haven't risen much. We see real, or inflation-adjusted, wage hikes to entice people back to work. That's good for the economy – but bad for company margins.



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Companies have managed to expand margins over the years through automation and other means, including in the pandemic. Now challenges are mounting. We see easing consumer demand as the restart of economic activity slows. This will reduce companies' ability to pass on higher costs to consumers, in our view. We also expect a rotation of consumer spending back into services and away from goods as the world normalizes – and see this helping the economy more than equities. Services make up most of the economy, whereas S&P 500 earnings are evenly split between services and goods.

The second reason we're not buying the dip: Equities haven't cheapened that much, in our view. Why? Valuations haven't really improved after accounting for a lower earnings outlook and a faster expected pace of rate rises. The prospect of even higher rates is increasing the expected discount rate. Higher discount rates make future cash flows less attractive.

Lastly, we're not pounding the table on buying stocks right now because of a growing risk that the Fed tightens too much – or that markets believe it will, at least in the near term. Signs of persistent inflation, like last week's CPI report, may fuel the latter risk. That's all part of why we turned tactically neutral on equities last month. Stocks slumped last week near lows of the year. We don't see a sustained rally until the Fed explicitly acknowledges the high costs to growth and jobs if it raises rates too high. That would be a signal to us to turn positive on equities again tactically.

We see central banks ultimately opting to live with inflation instead of raising policy rates to a level that destroys growth. That means inflation will likely stay higher than pre-Covid levels. We also think the Fed will quickly raise rates and then hold off to see the impact. The question is when this dovish pivot will take place. This uncertainty is why we're tactically neutral on stocks but overweight on a strategic, or longer-term, horizon. We think the sum total of rate hikes will be historically low.

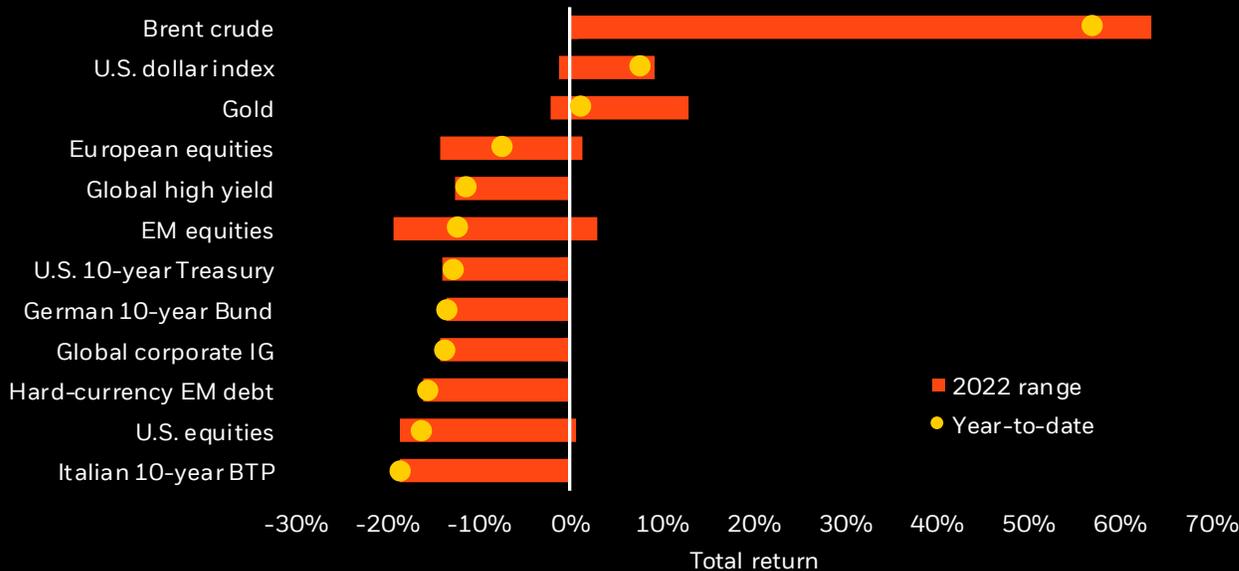
Bottom line: We are tactically neutral on stocks and are not buying the dip. First, valuations haven't really improved when taking into account faster rate hikes than the market had priced. Second, there's an increasing risk that the Fed overtighten or markets actually believe its tough talk on inflation. Third, a slowing restart and margin pressures spell trouble for heady earnings estimates in 2022 and 2023. We think central banks will eventually make a dovish pivot to save growth or avoid a deep recession. This is why we are overweight equities in the long run but neutral on a tactical horizon.

Market backdrop

U.S. CPI inflation data showed persistently high inflation last week, while the European Central Bank (ECB) announced plans to end asset purchases and carry out a rapid series of rate hikes. Stocks fell and yields rose, showing markets are primed to be hawkish on rates. We think the ECB and markets are underappreciating the risk that the energy crunch could bring the euro area to the brink of recession. We expect the ECB to accept this at some point and rethink its rate path.

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 June 9, 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.

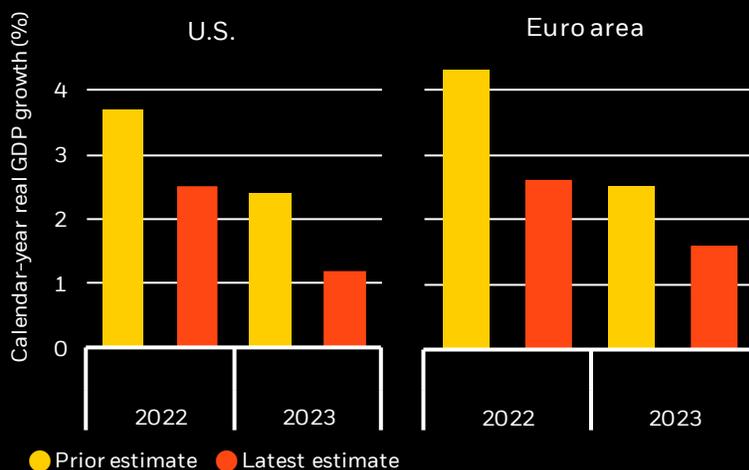
Macro insights

Economic growth forecasts for this year and the next are coming down rapidly. The OECD last week followed the World Bank in downgrading growth forecasts. It now sees the U.S. growing by 2.5% this year, versus a previous estimate of 3.7%. The euro area is expected to grow by 2.6%, down from 4.3%, and we see even greater downside risks there. See the chart.

What's dampening expectations? The war in Ukraine is hurting the post-pandemic restart. It has led to sky-high energy prices and a cost-of-living crisis that will reduce consumption – especially in regions that are net energy importers, like Europe. Plus, widespread lockdowns in China have slowed growth there. As the world's second-largest economy, that has ripple effects globally. Slowing growth and high inflation puts central banks in a bind. The only way to get inflation significantly lower is by raising interest rates to a level that slows growth even more. That's why we expect central banks to live with slightly above-target inflation for the foreseeable future. See our macro insights hub.

Less optimism on growth

U.S. calendar-year growth estimates, 2022-2023



Sources: BlackRock Investment Institute, OECD, June 2022. Notes: The chart shows estimates for calendar-year growth in 2022 and 2023, made by the OECD in their latest economic outlook and as of six months ago (prior).

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. Hiking interest rates too much risks triggering a recession, while not tightening enough risks causing unanchored inflation expectations. It's tough to see a perfect outcome.
- The Fed has made clear it is ready to dampen growth. It 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 unanchored inflation expectations has increased as inflation becomes more persistent.
- The Bank of England warned of the poisonous combination of recession and high inflation as it has raised interest rates to their highest level since 2009.
- The European Central Bank (ECB) announced plans to end asset purchases and implement a rapid series of rate hikes. We think the ECB and markets underappreciate the risk of the energy crunch putting the euro area on the brink of recession. We expect the ECB to accept this at some point and rethink its rate path.
- We believe the eventual sum total of rate hikes will be historically low given the level of inflation.
- **Investment implication:** We are neutral DM equities after having further trimmed risk.

2 Cutting through confusion

- We had thought the unique mix of events – the restart of economic activity, virus strains, production-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 jobs. Central banks can't cushion the growth shock.
- We see a worsening macro outlook because of persistently high inflation, the commodities price shock and the spillovers from a growth slowdown in China.
- **Investment implication:** We remain underweight U.S. Treasuries and overweight inflation-linked bonds.

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 energy 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 equity sectors better positioned for the green transition.

Week ahead

June 14

Germany ZEW sentiment report; Japan machinery orders

June 16

UK monetary policy decision; U.S. Philly Fed Business Index

June 15

U.S., Brazil monetary policy decisions

June 17

U.S. industrial production; Bank of Japan rate decision

The Fed will be front and center this week as it likely raises rates by 0.5%. Markets will focus on updated growth and inflation forecasts, indications of the future policy rate path and whether the Fed acknowledges that reducing inflation back to its 2% target would come at the cost of jobs and growth. We see the Fed hiking rates to a neutral level – one that neither stimulates nor drags on activity – by the end of the year, before pausing.

Directional views

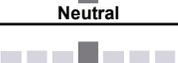
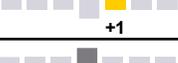
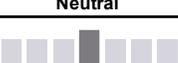
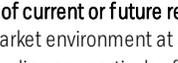
Strategic (long-term) and tactical (6-12 month) views on broad asset classes, June 2022

Asset	Strategic view	Tactical view
Equities	<p>+2</p>	<p>Neutral</p> <p>We are overweight equities in our strategic views, yet trimmed our overall tilt as the relative appeal versus bonds diminished. 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 neutral DM equities due to a higher risk of central banks overtightening policy and a deteriorating growth backdrop in China and Europe.</p>
Credit	<p>-1</p>	<p>Neutral</p> <p>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 had upgraded credit to neutral as the dramatic selloff this year 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.</p>
Govt bonds	<p>-1</p>	<p>-1</p> <p>We are strategically underweight nominal government bonds, with a preference for shorter-dated maturities over long-dated bonds. We see yields broadly climbing higher. We stay firmly underweight the long-end as 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.</p>
Private markets	<p>Neutral</p>	<p>Neutral</p> <p>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.</p>

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, June 2022

Asset	View	Commentary
Developed markets	 Neutral	We are neutral DM stocks due to uncertainty over policy amid a worsening macro picture. Their appeal relative to bonds has also diminished. The risk has risen that central banks slam the policy brakes as they focus solely on inflation without fully acknowledging the high costs to growth and jobs.
United States	 Neutral	We are neutral U.S. equities. The Fed's hawkish pivot has raised the risk that markets see rates staying in restrictive territory. The year-to-date selloff partly reflects this, yet we see no clear catalyst for a rebound.
Europe	 Neutral	We are neutral European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	 Neutral	We are neutral UK equities. We see the market as fairly valued, and we are not looking to chase the rally in the energy sector as transition to net zero unfolds.
Japan	 Neutral	We are neutral Japan stocks as part of a broader push to take more caution across DM equities.
China	 Neutral	We are neutral Chinese equities 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 given challenged restart dynamics, high inflation pressures and tight policies.
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 with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
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 are neutral European government bonds. 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 are neutral Chinese government bonds. Policymakers have been slow to loosen policy to offset the slowdown, and yields fell below U.S. Treasuries.
Global investment grade	 Neutral	We are neutral investment grade credit as this year's selloff 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.
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 are neutral Asia fixed income. 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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