Weekly commentary

July 5, 2022

BlackRock

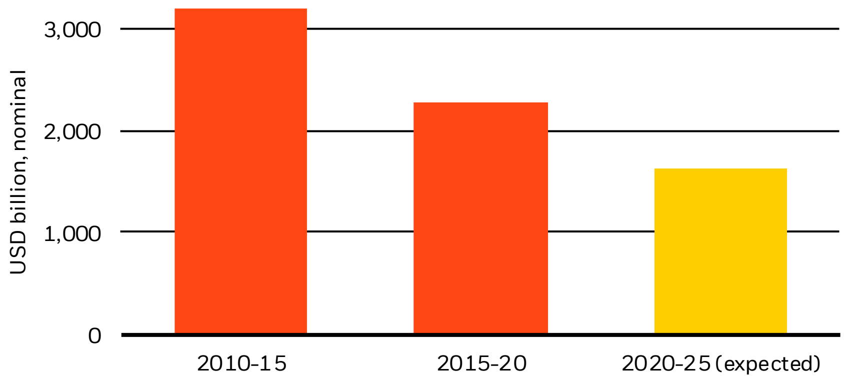
An era of higher commodities prices

- Commodities prices have spiked as demand from the restart clashed with tightening supply. We see the war and net-zero transition keeping prices high.
- U.S. and euro area inflation data last week showed still persistent inflation. Stocks and bond yields fell as markets priced more risk of rates hitting growth.
- Labor participation and wage growth are key to watch in this week's jobs data, we think, as the Fed weighs the magnitude of its next rate rise later this month.

We see an era of structurally higher commodities prices ahead. Why? First, look back. Prices ran up because the economic restart drove demand amid abnormally low supply. The West has tried to wean itself off Russian energy after years of declining investment. Now, look forward. We see structurally higher prices amid tight supply for energy and rising demand for metals that will be critical to power the path to reach net-zero carbon emissions by 2050.

Investment dearth

Global capex expenditure in oil and gas, 2010-2025



Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, Wood Mackenzie, June 2022. Note: The chart shows global capex expenditure in the oil and gas sector from 2010-2015 and from 2015-2020, as well as projected capex expenditure for the period 2020-2025.

Commodities prices and renewables have surged over the past two years, even with recent declines. Rate hikes choking off the restart could cause more dips. But we think prices are at structurally higher levels now. Why? The West is trying to wean itself off Russian supplies. The flow of Russian gas into Europe has fallen by two-thirds already in just a few months. This is a structural change, and we see it as part of accelerating geopolitical fragmentation. The supply crunch is rooted in years of declining investment from traditional energy companies (see the red bars in chart) and forecasters expect even less in years to come (the yellow bar). This hasn't been balanced by equally strong investment in clean energy supply. Lower capital expenditures are a result of both investors pushing for more capital discipline and concerns about long-term demand for traditional energy.

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Energy commodities prices are likely to be supported by growing energy demands amid tight supply in coming decades. Even with improving energy efficiency in developed markets, global energy demand could rise significantly, especially if energy consumption in emerging markets jumps markedly as living standards improve.

And even with rapid growth of clean energy infrastructure, it would be nearly impossible to meet energy demand in coming years without fossil fuels, as we say in a recent net-zero report. Some investment will likely still be needed in new fossil fuel production capacity to meet energy demand. Without capex, production generally falls as wells deplete. Current investment is below what is needed to meet demand in the short run, in our view, as capex has dropped by nearly half since 2014.

The buildout of clean energy infrastructure will boost demand for other commodities, too. Transition essentials like wind turbine farms and electric vehicles require staggering amounts of iron ore, copper, lithium and other metals to match fossil-fuel-generated power sources' outputs. Mineral demand for clean energy technology would have to rise by at least four times by 2040 to meet climate goals, according to the International Energy Agency.

The transition path remains uncertain. Last week's Supreme Court decision means the Environmental Protection Agency now has more limited regulatory authority in requiring utilities to reduce reliance on higher carbon sources of energy, unless Congress approves legislation. This reinforces our view that the invasion of Ukraine has created a more divergent transition globally as Europe doubles down on net-zero efforts. The same impetus isn't felt elsewhere.

What does all of this mean for investments? Time horizon is key. In the near term, we expect sharp rate rises from the Federal Reserve to choke off the restart of economic activity. That typically implies bad news for commodities or commodities producers – but not if we are in a new era of higher commodities prices. We see tactical opportunities in selected energy stocks after the recent selloff. They now appear priced for some retrenchment of energy prices, and we could see rising revenues and earnings amid the race to replace Russian supply.

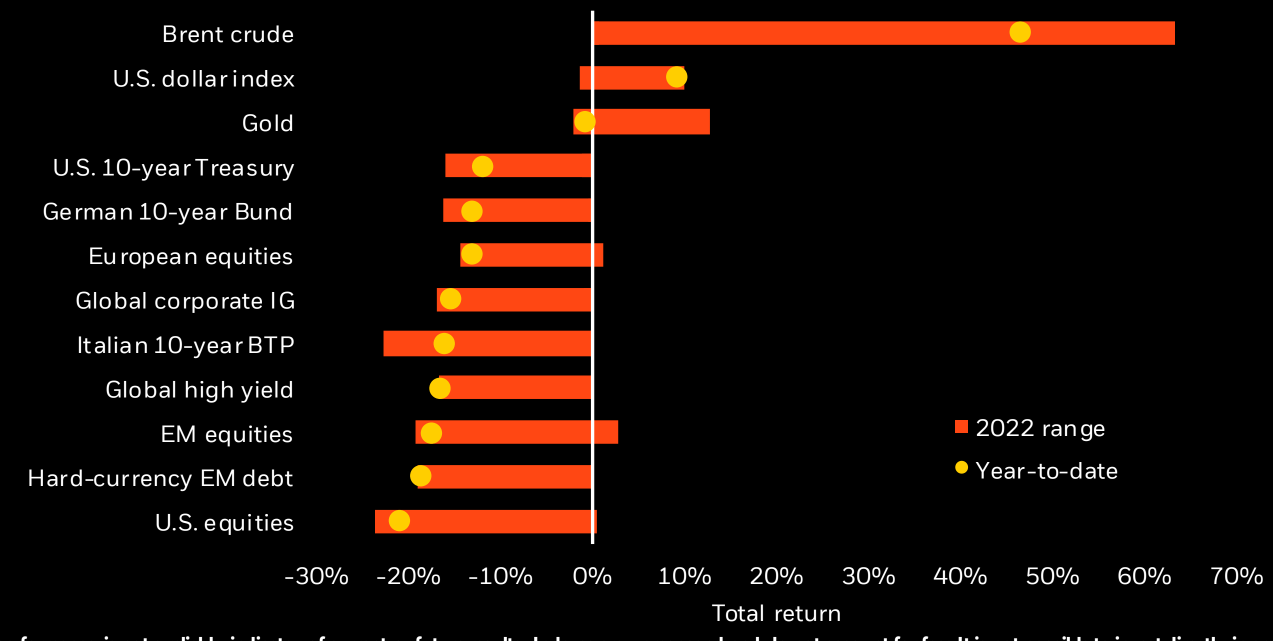
On a longer-term, strategic horizon, we believe lower-carbon sectors like tech and healthcare will benefit more than traditional energy stocks. At the same time, we think some of the greatest opportunities may be in carbon-intensive companies with credible decarbonization plans or companies supporting the transition with the supply of critical minerals.

Market backdrop

Stocks slid after U.S. and euro area data last week showed persistent inflation and signs of slowing economic activity. U.S. two-year Treasury yields posted their largest weekly drop since 2020. Short-term rate markets are signaling doubts central banks, including the Fed, will hike rates as high as their projections. Central bankers' talk on fighting inflation also gave little indication they face a policy trade-off: either crush growth or live with inflation. So we don't see this as a time to buy the dip.

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 30, 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

Consumers significantly changed their spending in the pandemic – spending more on goods and less on services. In fact, in less than 18 months, the preceding 18 years of decline in the share of goods in consumer spending reversed. See the chart. We've long said a sign of the economy getting back to normal after the pandemic would be spending switching back towards services. U.S. data last week suggest this has started and is gaining momentum – see the recent tick back down in the chart.

Why does that matter? That spending shift has been a key driver of inflation. The surge in demand for goods created bottlenecks and supply shortages, which in turn pushed up prices. As demand normalizes again, those supply issues should ease and inflationary pressure should start to subside. The risk is that consumer spending – on both goods and services – comes to a standstill. With the Fed increasing policy rates, the cost of finance is rising rapidly in the U.S. That typically deals a blow to economic growth. See our macro insights hub.

Spending rotating back to services

Goods share in total U.S. consumer spending, 2000-2022

Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, July 2022. Note: The chart shows U.S. goods spending as a share of total consumer spending.

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, raising rates by 0.75% in June in the largest increase since 1994. We ultimately think reality will come knocking and a stall in the restart will make the Fed change course.
- 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 further to 1.25% in June. This may indicate the start of a dovish pivot, in our view.
- The European Central Bank (ECB) announced plans to end asset purchases and implement a rapid series of rate hikes in an effort to stabilize peripheral bond yields. We think the ECB and markets underappreciate the risk of the energy crunch pushing the euro area into 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 but brace for volatility in the short run.
- **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

July 5	China services PMI; U.S. factory orders	**July 9**	China inflation data
July 8	U.S. jobs report		

The key focus in next week's U.S. jobs report will be signs the labor market is gradually healing – especially a recovery in labor participation. Labor shortages have added to U.S. inflation's march up to 40-year highs. We think wage growth may help the labor market normalize by enticing people back to the workforce and incentivizing them to stop hopping jobs for higher pay.

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+2	Neutral	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.
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 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.
Govt bonds	-1	-1	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.
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, July 2022

Underweight | Neutral | Overweight | ● Previous view

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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