Weekly commentary

September 6, 2022

BlackRock

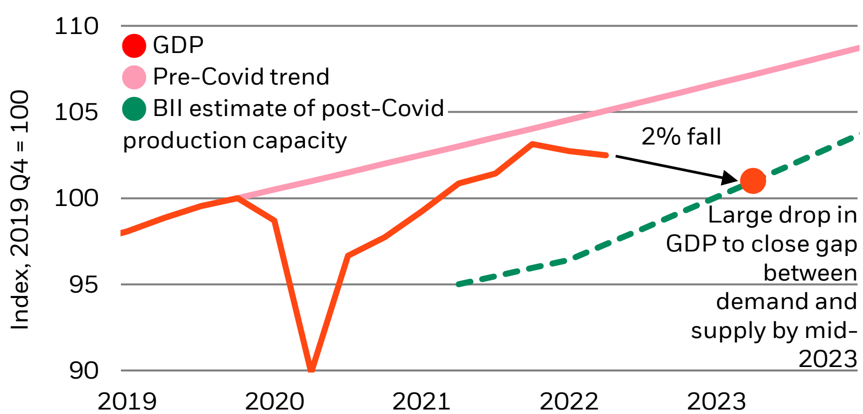
Recession looms as regime takes root

- Policymakers are recognizing a new macro regime but are ignoring the trade-off between inflation and growth. A resulting recession is bad news for risk assets.
- Stocks fell last week after hawkish comments by Fed Chair Jerome Powell and data showing another month of jobs gains. We see the Fed hiking through 2022.
- We expect the European Central Bank (ECB) to raise rates by 0.75% this week. We see it stopping well short of market projections in the face of recession.

We've argued for a while that we're in a new macro regime. Central bankers at the recent Jackson Hole forum started to recognize this reality. But we think they're not prioritizing economic implications over pressure to curb inflation. It seems they do not intend, for now, to manage the sharp trade-off between inflation and growth. That's a big deal. We think getting inflation back to central bank targets means crushing demand with a recession. That's bad news for risk assets in the near term.

Mind the growth gap

U.S. GDP and production capacity, 2019-2024



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, August 2022. Notes: The chart shows demand in the economy, measured by real GDP (in orange), and our projection of pre-Covid trend growth (in pink). The green dotted line shows our estimate of current production capacity. We infer that from how far core PCE inflation has exceeded the Federal Reserve's 2% inflation target.

The U.S. economy has already stalled. Now we see recession in the cards early next year. Powell made abundantly clear at Jackson Hole that the Fed has, for now, no intention of backing off its hiking cycle. The problem is that rate rises won't solve the biggest issue: low production capacity (see green dotted line in chart). The only way the Fed can get inflation down quickly is by raising rates high enough to force demand (orange line) down by around 2% to what the economy can comfortably produce now. That's well below the pre-Covid growth trend (pink line). But the Fed has yet to acknowledge the great cost to growth or the unusual nature of constraints in the labor market since the pandemic. We estimate 3 million more people would be unemployed if demand were to contract by 2%.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The Fed will be surprised by the growth damage caused by its tightening, in our view. When the Fed sees this pain, we think it will stop raising rates. It will be too late to avoid a contraction in economic activity by then, we think, but the decrease won't be deep enough to bring PCE inflation down to the Fed's target of 2%. Instead, we expect inflation to persist close to 3%.

Europe is a different story; we've expected recession there for months given the energy crunch. By year-end, rate rises will push the euro area into a deeper recession. The European Central Bank (ECB) appears just as determined as the Fed to fight inflation by raising rates. At Jackson Hole, ECB executive board member Isabel Schnabel acknowledged a trade-off between taming inflation and maintaining growth. Yet she stressed a "robust control" approach to monetary policy, focused on getting inflation down at whatever cost. We think the ECB will hike 0.75% on Sept. 8. But like the Fed, the ECB is not grasping the full extent of the recession needed to crush inflation, in our view. We think the ECB will keep raising rates through the rest of the year but stop earlier and well short of market projections when faced with the gravity of the recession.

What does this all mean for investments? The main conclusion: The new regime requires more frequent adjustments to portfolios. Time horizon is also key. In the short term, we're underweight developed market (DM) equities on a worsening macro outlook. Central banks look set to overtighten policy and stall the economic restart. The recessions we predict are not priced into equities, we think. That's why we aren't buying the dip. Longer term, we're modestly overweight DM equities. They have relative appeal over private growth assets – those have yet to reprice like their public counterparts – and fixed income, where we see higher yields dragging on expected returns. Sectors that we believe will benefit most from long-term trends like the net-zero transition, such as technology, are also particularly well represented in the DM equity universe.

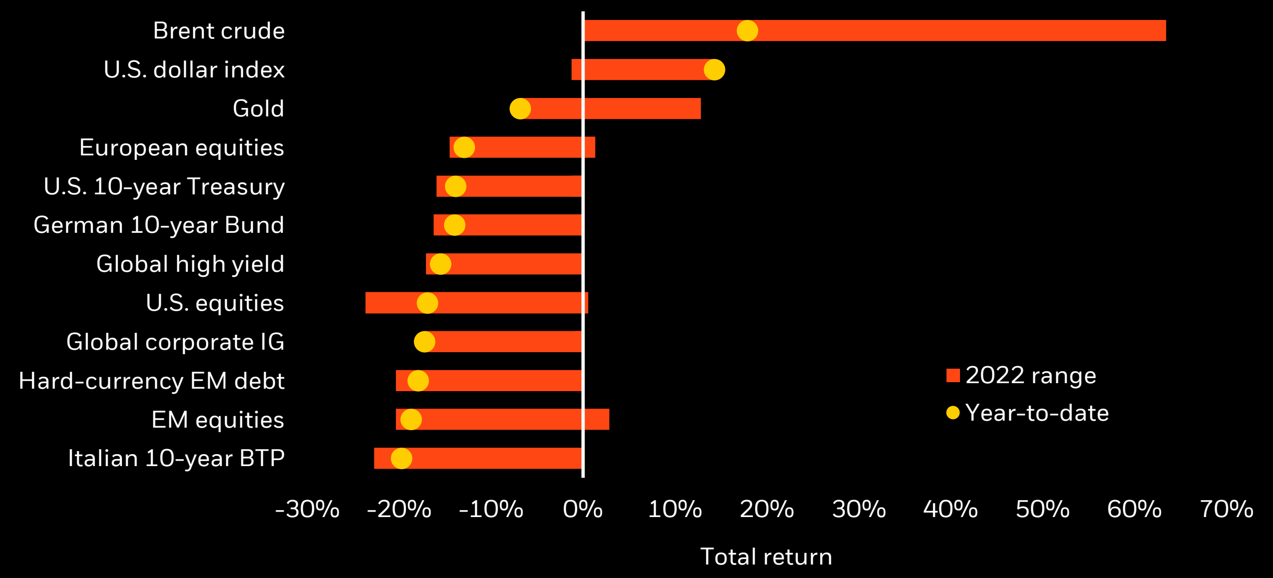
Publicly traded credit is an overweight in our strategic portfolios for the first time in years as yields and spreads have materially repriced. That includes high yield. Tactically, we prefer to be up in quality in investment grade since we think it could better weather a slowdown that equites haven't priced in yet. Lastly, we're overweight global inflation-linked bonds, now and even more so further out. Why? We think markets are once again underappreciating the persistence of higher inflation. We've been arguing all year we're in a new regime of heightened macro volatility driven by production constraints. In the near term, they are caused by Covid supply disruptions and labor shortages. In the long run, we see them pressured by structural forces such as a bumpy net-zero transition and a rewiring of global supply chains amid geopolitical tensions.

Market backdrop

Stocks ended lower in a volatile week after Powell's hawkish Jackson Hole comments about the Fed's "unconditional" objective to bring inflation back down to its 2% target. On Friday, U.S. jobs data showed another month of job gains alongside an increase in those searching for jobs. Given Powell's tone, we see the Fed hiking through this year and think it will only stop tightening once it sees the damage to growth and jobs from higher rates.

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 Sept. 1, 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.

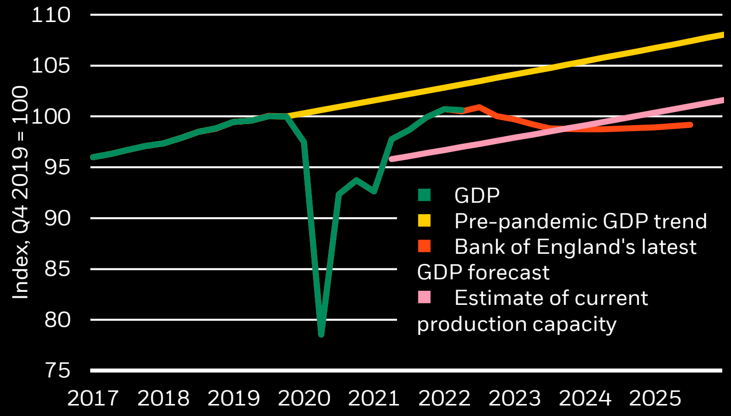
Macro take

Is honesty the best (monetary) policy? For the Bank of England (BoE), it is. Unlike other central banks, it has been honest that raising rates enough to get inflation back down to its 2% target would lead to a deep recession in the UK.

How so? We estimate the UK's production capacity (pink line in chart) – or the level of activity the economy can sustain without inflation surging - to be 5-6% lower than it would have been without the pandemic. That means the only way to have avoided an inflation problem would have been to choke off the economy's restart from pandemic lockdowns much earlier (stopping the green line going above the pink). Having not done that, the BoE, like the Fed in the U.S., must now either live with higher inflation or slam activity down to the pink line. The BoE's projections show getting inflation to 2% in 2024 would mean activity falling sharply, by 2.1%, next year (orange line). This honesty means the economic contraction starting to show in the data is unlikely to deter the BoE from hiking - although we think current market expectations go *too* far. Read more in our latest Macro Take.

Is honesty the best (monetary) policy?

UK GDP and production capacity, 2017-2025



Forward-looking estimates may not come to pass. Sources: BlackRock Investment Institute, UK ONS, Bank of England, with data from Haver Analytics, September 2022. Notes: The chart shows demand in the economy, measured by real GDP (in green), and our projection of pre-Covid trend activity (in yellow). The pink line shows our estimate of current production capacity, inferred from how far core inflation has exceeded the 2% target. The orange line shows the Bank of England's latest GDP forecast.

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage gives policymakers less maneuvering room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S., we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** Be nimble. We're tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a new world shaped by supply. Major spending shifts and production constraints are driving inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns.
- The Fed increased rates by another 0.75% in July and reaffirmed projections of more rate rises with the aim to rein in inflation. At Jackson Hole, Fed Chair Jerome Powell emphasized that the inflation objective is "unconditional." We think this leaves the Fed with no room to back off its hiking intention – and now that can only happen after the Fed is surprised by the growth damage rate hikes will cause.
- The Bank of England raised rates to 1.75% in August. It also acknowledged the growth-inflation trade-off. It now sees a protracted recession through 2023, partly due to the energy shock.
- The ECB surprised with a larger-than-expected 0.5% rate rise in July. It also announced a new bond-buying facility to limit risks of higher rates causing the euro area to fragment. The ECB and markets underappreciate the risk of the energy crunch causing a recession, we think. The ECB will eventually accept this and rethink its rate path.
- **Investment implication**: We are tactically underweight most DM equities after having further trimmed risk.

3 Positioning for 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.
- We see a global drive for more energy security accelerating the transition in the medium term, especially in Europe.
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like 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**: Time horizon is key. We see tactical opportunities in selected energy stocks.

Week ahead

Sept. 5	China Caixin services PMI	**Sept. 8**	ECB monetary policy meeting
Sept. 7	China trade data; U.S. trade data	**Sept. 9**	China PPI and CPI data

The ECB will be the center of attention this week, and we expect it to raise rates by 0.75%. An ECB executive board member's comments at Jackson Hole suggest the central bank is starting to acknowledge that reducing inflation to its 2% target will come at a sizable cost to jobs and growth. We'll be assessing how much that's reflected in the ECB's updated forecasts. We see the ECB hiking rates through 2022 and then stopping amid an energy shock-triggered recession.

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views. A higher risk premium and worsening macro backdrop lowers our expected equity returns. But we expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we're underweight DM stocks as central banks look set to overtighten policy – we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	+1	+1	Strategically, we are overweight publicly traded credit – from high yield to global investment grade. Higher spreads and government bond yields push up expected returns, and we think default risk is contained. Additionally, income potential is attractive. Tactically, we're overweight investment grade but neutral high yield. We prefer to be up in quality. We overweight local-currency EM debt on attractive valuations. A large risk premium compensates investors for inflation risk, in our view.
Govt bonds	-1	-1	A modest underweight in our strategic view on government bonds reflects a big spread: max underweight nominal, max overweight inflation-linked and an underweight on Chinese bonds. We see nominal yields in five year's time significantly higher than current levels. That repricing is a valuation drag on expected returns. We also think markets are underappreciating the persistence of high inflation. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022.
Private markets	-1	—	We're underweight private growth assets and neutral on private credit, from a starting allocation that is much larger than what most qualified investors hold. Private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class 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, September 2022

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

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings.
Europe	-1	We are underweight 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	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are 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.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. Markets are underappreciating the inflationary pressures from the energy shock, we think.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	+1	We are overweight UK gilts. Gilts are our preferred nominal government bonds. We believe market pricing of the Bank of England's rate hikes is unrealistically hawkish in light of deteriorating growth.
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
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 inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

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