

Weekly commentary

May 30, 2023

BlackRock

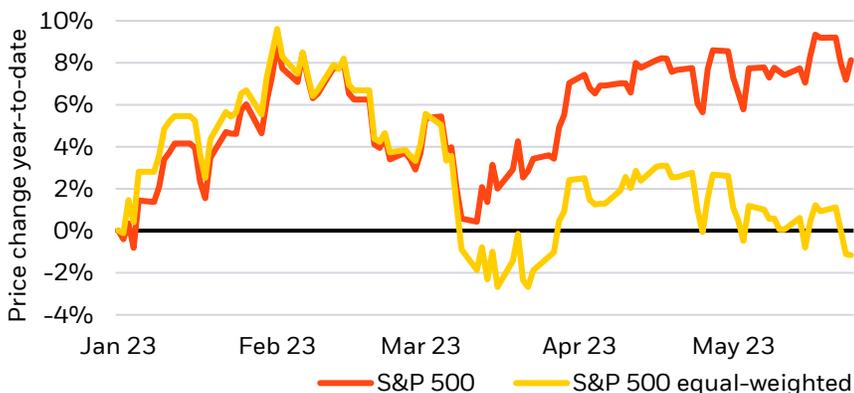
Markets now accept rate cuts unlikely

- Inflation has proven sticky, even as growth weakens. Markets are realizing that policy rates are set to stay higher for longer. We like quality in stocks and bonds.
- Tech stocks surged further last week even as debt ceiling talks spurred bouts of volatility. Long-term bond yields climbed on still hot U.S. inflation in April.
- U.S. jobs data this week should show a tight labor market is keeping wage pressures elevated. We think that keeps inflation sticky and above policy targets.

We've been saying since the end of 2022 that rate cuts this year would be unlikely as inflation sticks around. Markets are waking up to our view as a look under the hood reveals signs of weaker growth in major economies and market weakness due to rate hikes. Debt ceiling talks and the U.S. Treasury potentially being unable to pay its bills by early June have added to recent market volatility. We like quality in portfolios. We upgrade UK gilts to neutral as yields price in more rate hikes.

A big divergence

U.S. equities market cap vs. equal weighted price change year-to-date



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2023. Notes: The chart shows the price index change for the S&P 500 Composite Index (market-capitalization weighted) and S&P 500 Equal-weighted Index since the start of 2023 through May 25, 2023.

Stubbornly high inflation has prompted the Fed's fastest rate hike campaign since the 1980s. Markets are no longer pricing in repeated Fed rate cuts, a sign they're grasping inflation's persistence, in our view. And the full effect of central banks' rate hikes is kicking in. Data last week showed Germany has entered recession even with a smaller-than-feared energy shock. In the U.S., GDP has held up but it has arguably entered recession based on gross domestic income, which assesses the economy's performance on an income rather than spending basis. A deeper look reveals stocks reflect worsening growth: The S&P 500 index was up nearly 10% so far this year (dark orange line in the chart). But a few large technology firms valued above \$200 billion are driving those gains as they benefit from artificial intelligence buzz. Applying equal weighting to all companies in the index regardless of size shows it's down over 1% this year (yellow line) – extending 2022's hefty losses.



Jean Boivin

Head – BlackRock Investment Institute



Wei Li

Global Chief Investment Strategist – BlackRock Investment Institute



Alex Brazier

Deputy Head – BlackRock Investment Institute



Nicholas Fawcett

Macro Research – BlackRock Investment Institute

Visit [BlackRock Investment Institute](#) for insights on the global economy, markets and geopolitics.

BlackRock Investment Institute

Inflation and wage growth remain sticky, even with this deteriorating growth picture. Why? U.S. consumer spending’s shift back to services from goods caused core inflation to fall at first. Yet labor constraints persist, with unemployment still near historic lows. We think tight labor markets are keeping wage gains high, making overall inflation stubborn. April PCE inflation data out last week confirmed that. Inflation is running even hotter in Europe, especially the UK. Central banks face a clear trade-off, in our view: crush activity to ease labor constraints and curb inflation – or live with some above-target inflation.

We see the Fed nearing a pause in rate hikes and living with some inflation to avoid the deep recession needed to get inflation near its target. But we don’t see the Fed coming to the rescue of a faltering economy with rate cuts later this year due to the sharp trade-off between inflation and growth. Markets are coming around to our long-held view after having until recently priced in repeated rate cuts in 2023. We think the European Central Bank will hike more, regardless of the economic damage. The Bank of England (BOE) is in a similar position. Markets have priced in as many as four more BOE hikes. We think that might be a bit overdone, as it would be equivalent to the Fed hiking to around 7-7.5% – enough to trigger a severe recession.

We have a relative preference for UK gilts given this outlook. We close our previous underweight on UK gilts as yields return near levels reached during last September’s turmoil. We favor quality in our portfolio. We’re neutral investment grade credit and think yields above 5% compensate for wider spreads due to any downturn. We’re overweight emerging market (EM) local currency debt given peaking EM rates and a broadly weaker U.S. dollar. We also look for quality in equities, with a preference for companies that are able to grow their earnings and wield pricing power to pass on higher costs. Cushioning portfolios from inflation is also key. We like inflation-linked bonds as markets underestimate the persistence of U.S. inflation but better appreciate it in Europe, we think. On a strategic horizon of five years or more, we lean into real assets that can buffer inflation like infrastructure and industrial properties. Strategically, we see returns for developed market (DM) stocks above bonds’ as growth returns and inflation lingers in the U.S. DM stocks look riskier to us in the near term than fixed income given current yields. Debt ceiling concerns have upped market volatility, but we see the growth-inflation trade-off as a bigger driver of volatility longer term. We prefer EM stocks as they better price in the damage, yet China’s growth stalling would pose risks.

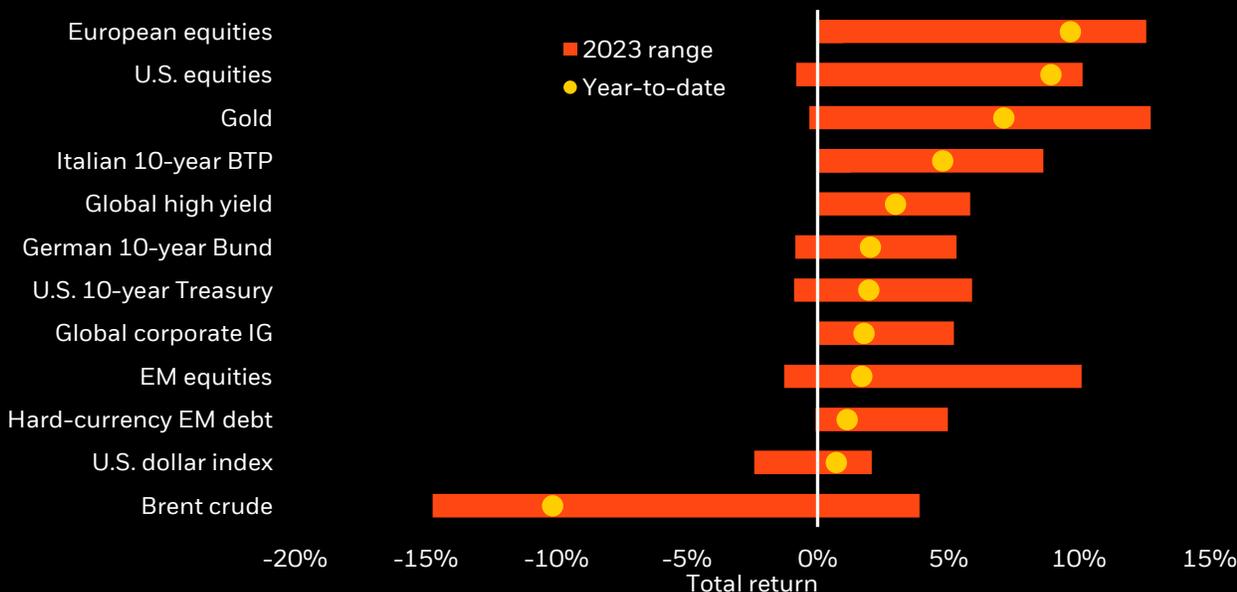
Bottom line: Markets are reassessing policy rate expectations as sticky inflation makes clear central banks won’t cut them this year – or will keep hiking. We turn to high quality sources of income in the short term and stay cautious on risk assets.

Market backdrop

Major tech stocks surged further last week, leading U.S. stocks slightly higher – even as the U.S. potentially facing a technical default dominated market attention. Meanwhile, long-term Treasury yields climbed after data showed that April U.S. PCE inflation remained hot. A credit rating agency warning it could downgrade the top notch Treasuries rating if the U.S. defaults reinforces our view investors will demand more compensation for holding long-term bonds given higher policy rates.

Assets in review

Selected asset performance, 2023 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 25, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, 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

The latest economic data from Germany suggests that the economy shrank for the second quarter in a row – indicating a technical recession. Germany's GDP has now dropped below its pre-Covid level. See the chart.

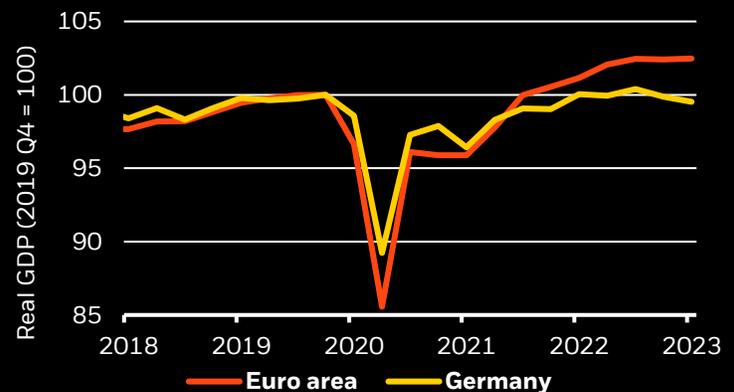
Energy prices surged following Russia's invasion of Ukraine last year, squeezing real incomes and dragging consumer spending down. German manufacturers suffered from both higher prices and shortages of crucial equipment.

The energy shock fading would usually indicate better times ahead. But we see the delayed impact from the European Central Bank's (ECB) rapid rate rises kicking in as the energy shock fades. And that's why we expect economic activity to contract across the euro area later this year. A contraction should help bring core inflation down from its current highs, but we still see inflation persisting above the ECB's 2% target in the coming quarters. That leaves no room for the ECB to consider cutting interest rates this year, in our view.

Explore our recent Macro take blog posts [here](#).

Contracting activity

Euro area and Germany real GDP, 2018–2023



Source: BlackRock Investment Institute, Eurostat, with data from Haver Analytics, May 2023. Notes: The chart shows demand in the economy, measured by real GDP, for the euro area and Germany, rebased to Q4 of 2019.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication:** We prefer very short-term government paper over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The Fed's rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication:** We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

May 31

China manufacturing PMI

June 2

U.S. payrolls

June 1

Euro area inflation; U.S. manufacturing PMI

We're watching key inflation and labor market data in developed markets this week. We see wage pressures from a tight labor market in the U.S. and euro area keeping core inflation above policy targets for some time. We expect some easing of labor market tightness as the lagged effect of rate hikes by major central banks starts to hit economic activity.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2023

	Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view		Tactical view	
Equities	<p>+1</p>		<p>-1</p> <p>We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.</p>	
Credit	<p>Neutral</p>		<p>Neutral</p> <p>Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.</p>	
Govt bonds	<p>Neutral</p>		<p>-1</p> <p>We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.</p>	
Private markets	<p>Neutral</p>		<p>—</p> <p>We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, 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.</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, May 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary	
Equities	Developed markets	<p style="text-align: center;">-1</p>	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
	United States	<p style="text-align: center;">-1</p>	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	<p style="text-align: center;">-1</p>	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	<p style="text-align: center;">-1</p>	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	Japan	<p style="text-align: center;">-1</p>	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	Emerging markets	<p style="text-align: center;">+1</p>	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
	China	<p style="text-align: center;">+1</p>	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
	Asia ex-Japan	<p style="text-align: center;">Neutral</p>	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
	Long U.S. Treasuries	<p style="text-align: center;">-1</p>	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
	Short U.S. Treasuries	<p style="text-align: center;">+2</p>	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
Fixed Income	Global inflation-linked bonds	<p style="text-align: center;">+2</p>	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	<p style="text-align: center;">-1</p>	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	<p style="text-align: center;">Neutral</p>	We are neutral. We find gilt yields attractive as they have risen back near levels reached during 2022's budget turmoil. We prefer short-dated gilts for income.
	China govt bonds	<p style="text-align: center;">Neutral</p>	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	Global IG credit	<p style="text-align: center;">Neutral</p>	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
	U.S. agency MBS	<p style="text-align: center;">Neutral</p>	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
	Global high yield	<p style="text-align: center;">-1</p>	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
	Emerging hard currency	<p style="text-align: center;">Neutral</p>	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
	Emerging local currency	<p style="text-align: center;">+1</p>	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
	Asia fixed income	<p style="text-align: center;">Neutral</p>	We are neutral. We don't find valuations compelling enough yet to turn more positive.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on macroeconomics, sustainable investing, geopolitics and portfolio construction to help BlackRock's portfolio managers and clients navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive and no representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. The opinions expressed are as of May 30, 2023 and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.

In the **U.S. and Canada**, this material is intended for public distribution. **In the European Economic Area (EEA):** this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded. **In the UK and Non-European Economic Area (EEA) countries:** this is Issued by BlackRock Advisors (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL, Tel: +44 (0)20 7743 3000. Registered in England and Wales No. 00796793. For your protection, calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock. **In Italy,** for information on investor rights and how to raise complaints please go to <https://www.blackrock.com/corporate/compliance/investor-right> available in Italian. **For qualified investors in Switzerland:** This document is marketing material. This document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA"). For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: www.blackrock.com/finsa. **For investors in Israel:** BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. **In South Africa,** please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. **In the DIFC** this material can be distributed in and from the Dubai International Financial Centre (DIFC) by BlackRock Advisors (UK) Limited – Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it. BlackRock Advisors (UK) Limited - Dubai Branch is a DIFC Foreign Recognised Company registered with the DIFC Registrar of Companies (DIFC Registered Number 546), with its office at Unit 06/07, Level 1, Al Fattan Currency House, DIFC, PO Box 506661, Dubai, UAE, and is regulated by the DFSA to engage in the regulated activities of 'Advising on Financial Products' and 'Arranging Deals in Investments' in or from the DIFC, both of which are limited to units in a collective investment fund (DFSA Reference Number F000738) **In the Kingdom of Saudi Arabia,** issued in the Kingdom of Saudi Arabia (KSA) by BlackRock Saudi Arabia (BSA), authorised and regulated by the Capital Market Authority (CMA), License No. 18-192-30. Registered under the laws of KSA. Registered office: 29th floor, Olaya Towers – Tower B, 3074 Prince Mohammed bin Abdulaziz St., Olaya District, Riyadh 12213 – 8022, KSA, Tel: +966 11 838 3600. The information contained within is intended strictly for Sophisticated Investors as defined in the CMA Implementing Regulations. Neither the CMA or any other authority or regulator located in KSA has approved this information. The information contained within, does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. Any distribution, by whatever means, of the information within and related material to persons other than those referred to above is strictly prohibited. **In the United Arab Emirates** is only intended for - natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. **In the State of Kuwait,** those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. **In the Sultanate of Oman,** to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. **In Qatar,** for distribution with pre-selected institutional investors or high net worth investors. **In the Kingdom of Bahrain,** to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. The information contained in this document, does not constitute and should not be construed as an offer of, invitation, inducement or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. **In Singapore,** this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. **In Hong Kong,** this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. **In South Korea,** this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations). **In Taiwan,** independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In Japan,** this is issued by BlackRock Japan. Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No 375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In Australia,** issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL). The material provides general information only and does not take into account your individual objectives, financial situation, needs or circumstances. **In China,** this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. **For Other APAC Countries,** this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions). **In Latin America,** no securities regulator within Latin America has confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico thus is subject to strict rules. For more information on the Investment Advisory Services offered by BlackRock Mexico please refer to the Investment Services Guide available at www.blackrock.com/mx

©2023 BlackRock, Inc. All Rights Reserved. **BLACKROCK** is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

BlackRock

Not FDIC Insured • May Lose Value • No Bank Guarantee