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Weekly commentary

BlackRock

January 10, 2022

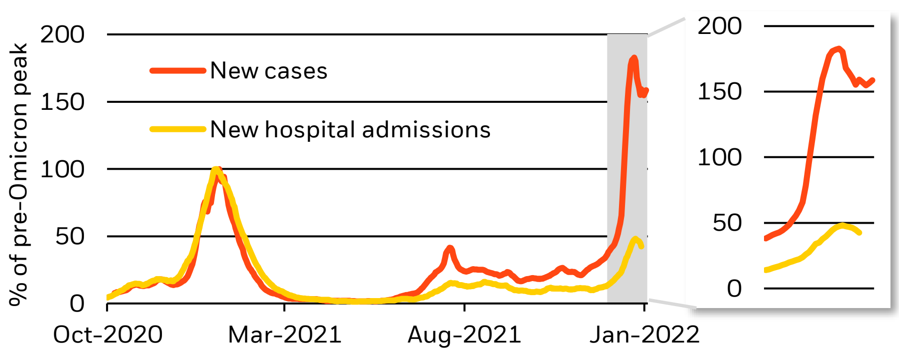
Virus spike to delay, not derail, restart

- We see Omicron delaying – but not derailing - the powerful activity restart even as its impact will differ by country. We keep favoring equities as a result.
- Stocks and bonds fell after the Fed indicated a potentially faster-than-expected normalization. We think it's important to look through any knee-jerk reaction.
- Investors will get a read on the persistence of U.S. inflation this week, while Chinese credit data may provide clues on the speed of policy loosening.

The new year has started with a record COVID surge, renewed restrictions and many people working from home again. The difference with this time: The Omicron strain appears less severe in populations with high vaccination and immunity rates. We see Omicron delaying – and not derailing - the powerful restart of economic activity while potentially adding to supply bottlenecks. We stay overweight equities and eye risks that policymakers or markets misread the current surge in inflation.

A less severe virus strain

London COVID-19 cases and hospital admissions vs. previous peaks, 2020-2022



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from UK Coronavirus (COVID-19) Dashboard . Notes: Chart shows London COVID-19 cases and hospital admissions compared with their January 2021 peak level. Hospital admission data are adjusted by seven days to account for the lag between cases and admissions.

Markets have started the new year on a jittery note, with worries centering on Fed rate rises and policy normalization. We urged investors to stay invested through COVID-related volatility as we believed the strain would ultimately only delay the powerful restart of economic activity that has underpinned a surge in corporate profits. More clarity on Omicron in the past weeks has strengthened our conviction, even as the COVID surge may look frightening. Why? First, vaccines and prior infections have proven effective against severe disease even as their efficacy against Omicron infection has fallen. Second, scientific studies are suggesting Omicron is intrinsically somewhat less severe than previous strains. Third, populations have gained higher immunity as more people have caught COVID or received boosters. All this suggests a surge in cases but a more muted rise in hospitalizations. We view the situation in the recent Omicron hot spot of London as a harbinger of things to come. Case loads spiraled upward to almost double the previous peak in early 2021 (the red line in the chart). Yet hospital admissions have remained 50% below the earlier highwater mark (the yellow line).

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Both case loads and hospitalizations in London have started to come down, suggesting the worst of the Omicron wave may be over. We expect other areas to follow a similar pattern over the next couple of months. The caveats: Outcomes will likely be worse elsewhere as the UK sports high vaccination, booster and immunity rates. And pressure on hospitals and services in general is set to mount as they already face staff shortages. Check out our COVID-19 tracker for the latest trends.

The key question is how China's zero-COVID policy will stand up against Omicron. The policy so far has proven effective and enjoyed popular support, but has left China with almost no natural immunity. We expect the country to maintain the policy – at least optically – in this politically important year. This raises the specter of more restrictions on activity, from targeted measures that keep the economy humming (Shanghai) to full-scale lockdowns (Xi'an). As a result, we believe downside risks to China's growth have risen, even as Beijing appears bent on achieving its growth target this year by loosening policy. The big picture on Omicron remains that we see it only delay the powerful global restart. Less growth now means more growth later, in our view. Omicron also may have a silver lining. Its highly infectious nature may turn COVID into an endemic disease similar to the flu as populations build up immunity and annual booster shots keep down the human toll.

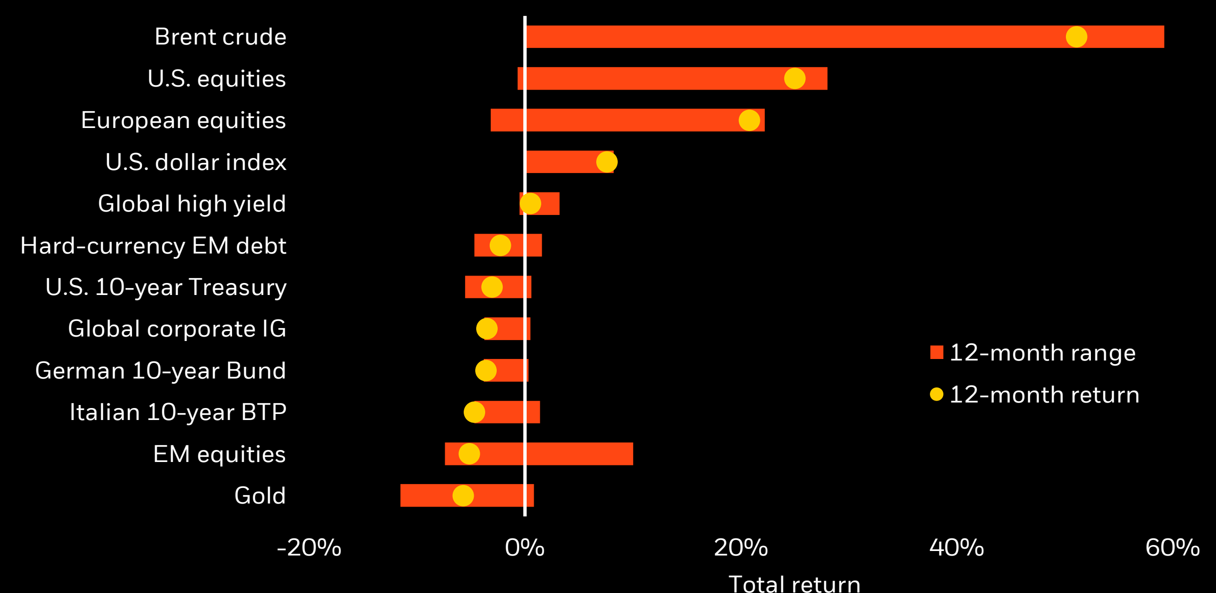
Risk assets showed clear concern about the Fed over Omicron last week. Policymakers and markets may misread the unique mix of the restart, a mutating virus, supply-driven inflation and new central bank policies. Our base case: Central banks take their foot off the gas pedal to move away from emergency stimulus. We expect them to live with inflation, rather than hit the brakes by raising rates to restrictive levels. The Fed has signaled three rate rises this year – more than we expected. Markets seem primed to equate higher rates as being negative for equities. We've seen this before and don't agree. What really matters is that the Fed has kept signaling a low sum total of rate hikes, and that didn't change last week. This historically muted response to inflation should keep real policy rates low, in our view, supporting equities. And not all spikes in long-term yields are the same. Last week's jump in U.S. Treasury yields was about the Fed signaling a readiness to start shrinking its balance sheet. This could result in a return of the term premium that investors typically demand for the risk of holding long-term bonds. This is not necessarily negative for risk assets as it can reflect an investor preference for equities over government bonds. Our bottom line: We prefer equities and would use COVID-related selloffs to add to risk. We are underweight developed market government bonds – we see yields gradually heading higher but staying historically low.

Market backdrop

Stocks and bonds fell after minutes from the Fed's December meeting indicated a potentially faster-than-expected policy normalization, including speeding up the timeline for trimming its bond portfolio. The big picture remains that major central banks have indicated a historically muted response to rising inflation. This should keep real yields negative and support equities. We see inflation settling at a level higher than pre-COVID even as pressures from supply bottlenecks ease.

Assets in review

Selected asset performance, 12-month return and range



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Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of January 7, 2022. Notes: The two ends of the bars show the lowest and highest returns at any point over the last 12-months and the dots represent current 12-month 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, in descending order: spot Brent crude, MSCI USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, spot gold, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

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Macro insights

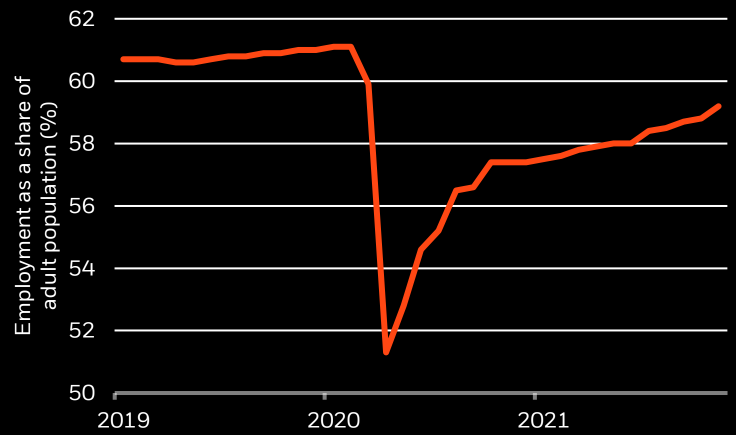
Employment in the U.S. is recovering, gradually removing the final hurdle for the Federal Reserve to kick off raising policy rates. The Fed has already met its inflation mandate, so the focus now is on how the central bank interprets its goal of "broad-based and inclusive employment."

The employment-population ratio – the share of adults who are employed – has been steadily increasing since employment plunged in 2020 amid Covid-19 shutdowns. See the chart. How much further can it improve? That depends on how many unemployed are actively looking for work versus how many have stopped looking or retired. Some people may have left the labor force for good, so the Fed could see its employment goal as met even if the ratio doesn't fully recover.

December's payrolls gain was below expectations but the report saw a further improvement in the labor participation rate, paving the way for the Fed's first hike by the middle of this year. Timing aside, we believe what matters most is that the cumulative path of rate hikes will be more muted than in past episodes of higher inflation. See our macro insights hub.

Employment key to start of Fed hikes

U.S. employment-population ratio, 2019-2021



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, January 2022. Notes: The chart shows the U.S. employment-population ratio, defined as the share of those in the adult population (aged 16 or over) who are in employment, according to the U.S. monthly household survey.

Investment themes

1 Living with inflation

- We expect inflation to be persistent and settle above pre-Covid levels. We expect central banks to kick off rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.
- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve over the year.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation, even as the Fed has started to warn of inflation risks.
- Other developed market (DM) central banks have signaled policy rate paths with steeper initial increases, and many of their emerging market (EM) counterparts have already lifted off.
- The Fed has achieved its new inflation goal to make up for past misses and sees full employment being reached this year. This is the justification for the three rate hikes it has suggested for 2022. This is more than we expected, but we believe the total sum of hikes is unchanged and historically muted – and more important to markets.
- The Fed has sped up its tapering of bond purchases and has indicated it may start to trim its balance sheet earlier than expected by letting bonds run off when they mature.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- A 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 keep the big picture in mind: We see the restart rolling on, inflation meeting a muted central bank response, and real rates remaining historically low.
- We do see increasing risks around this base case: Central banks could revert to their old policy response, and growth could surprise on the upside or disappoint.
- There's also a risk markets misread China's policy. The country has emphasized social objectives and quality growth over quantity in regulatory crackdowns that have spooked some investors. Yet policymakers can no longer ignore the growth slowdown, and we expect incremental loosening across three pillars - monetary, fiscal and regulatory.
- **Investment implication:** We have trimmed risk-taking amid an unusually wide range of outcomes.

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.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. 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.

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Week ahead

Jan. 10-17	China money and credit data; Euro area unemployment rate
Jan. 12	China and U.S. CPI inflation data
Jan. 14	U.S. industrial production and University of Michigan sentiment

Investors will get a read on the persistence of U.S. consumer price inflation this week, while Chinese credit data may provide clues on the speed of policy loosening. The powerful economic restart has driven U.S. inflation rates to its highest rate in decades. This means the Federal Reserve has clearly met its average inflation target under its new framework, helping open the door for interest rate rises this year.

Directional views

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

Underweight **Neutral** **Overweight**

Change in view
Previous New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight on equities on a strategic horizon. We see the combination of low real rates, strong growth and reasonable valuations as favourable for the asset class. 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 overweight equities amid solid economic fundamentals and historically low real rates.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich, and we prefer to take risk in equities instead. On a tactical horizon, we are neutral credit given low spreads across sectors and prefer EM local markets to high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Within the underweight on nominal DM government bonds, we prefer shorter-dated over long-dated maturities. Rising debt levels may eventually pose risks to the low rate regime. We prefer inflation-linked bonds. Tactically, we keep our significant U.S. Treasuries underweight on expectations of rising yields into the Fed's taper and rate kick-off. We prefer inflation-linked bonds for interest rate exposure and as a portfolio diversifier.
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, January 2022. 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, January 2022

Underweight **Neutral** **Overweight**

Change in view
Previous New

	Asset	Underweight	Overweight	
Equities	**Developed markets**		■	We are overweight developed market equities. We see still solid growth and low real yields supporting valuations. We prefer to diversify our exposure.
	United States		■	We are overweight U.S. equities on still strong earnings momentum. We do not see gradual policy normalization posing significant headwinds.
	Europe		■	We stay modestly overweight European equities given attractive valuations. We believe the rise in Covid infections may stall but not derail the restart
	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
	Japan			We have a small overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
	China		■	We stay moderately positive on Chinese equities as we see a shift to a slightly easier policy. We expect the regulatory clampdown to last but not intensify.
	Emerging markets			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
Fixed Income	U.S. Treasuries	■■		We are underweight U.S. Treasuries primarily on economic fundamentals and valuations. We see risks tilted toward higher yields into the Fed taper and subsequent lift-off.
	Treasury Inflation-Protected Securities		■	We stay overweight U.S. TIPS as we expect inflation to be persistent and settle at a higher level than pre-Covid. We prefer TIPS for interest rate exposure and diversifiers.
	European government bonds	■		We keep our underweight European government bonds. We see yields heading higher. Current market pricing points to no substantive change in monetary policy for several years.
	UK gilts			We are neutral UK Gilts. We see UK policy rates rising before DM peers, yet believe market expectations of the subsequent pace are overdone amid constrained supply.
	China government bonds		■	We are overweight Chinese government bonds. Potentially easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
	Global investment grade	■		We stay underweight investment grade credit. We see little room for further yield spread compression and remain concerned about interest rate risk.
	Global high yield			We are neutral high yield. We do not see compression in high yield spreads yet still find the carry attractive. We prefer to take risk in equities.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency		■	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.
	Asia fixed income		■	We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income and carry.

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