Weekly commentary

May 2, 2022

BlackRock.

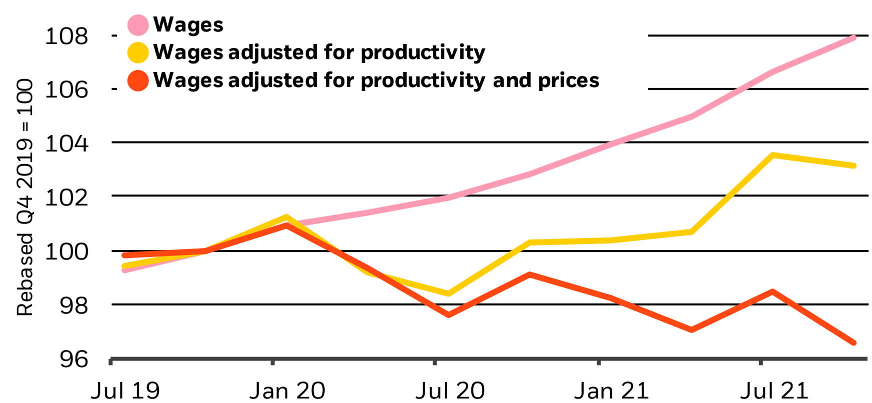
Wage-price spiral ahead? Not really

- We don't see a wage-price spiral. Companies are actually paying *less* in labor per unit of output, we find. We think wages can rise more without adding to inflation.
- The S&P 500 plunged to new 2022 lows last week. We remain overweight equities in the inflationary backdrop but acknowledge mounting challenges.
- The Fed is set to raise its policy rate by 0.5% this week in an attempt to rein in inflation. We think the eventual sum total of rates hikes will be historically low.

U.S. wages are growing at the fastest clip since the 1980s. Is this the start of a "wage-price spiral" – a vicious cycle of companies funding higher pay by raising prices, causing employees to ask for even higher wages? We don't think so. In reality, we find companies are paying *less* in labor costs per unit of output than before the pandemic thanks to higher productivity and prices. We believe wages can rise further without adding to inflation – and help normalize the labor market.

Real wages have room to rise

U.S. labor costs, 2019-2021



Sources: BlackRock Investment Institute, with data from Haver Analytics. Notes: The chart shows the level of U.S. private wages and salaries (in pink) from the U.S. employment cost index measure of hourly labor costs. The yellow line shows this measure of wages adjusted for productivity, by dividing by the level of output per hour. The red line shows this productivity-adjusted series adjusted for inflation by dividing by the U.S. personal consumption expenditure headline price index.

Wages measured by the Employment Cost Index jumped 5% last year – the fastest pace since the 1980s (pink line in the chart). Some argue this is evidence of an overheating job market and a precursor to spikes in consumer prices. But higher wages don't necessarily mean higher inflation. What matters for companies is the real unit labor cost: how much a company pays workers to produce a unit of output relative to that unit's selling price. U.S. workers are 4.5% more productive than before the pandemic, according to Bureau of Labor Statistics data. Wages have actually fallen since then (the red line), after adjusting for those productivity gains (the yellow line) and higher prices. Our conclusion: Wages have room to rise as they catch up with productivity and price gains, rather than drive more inflation pressure.

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How about other ostensible signs of an overheating labor market? The U.S. unemployment rate is at a pre-pandemic low. The ratio of vacancies to unemployed is at the highest level on record. We believe this is caused by a labor market still healing from the pandemic, rather than excessive demand for labor. People are quitting at record rates to improve their compensation (the "Great Renegotiation"), and the unemployed are reluctant to fill job openings. This means ballooning vacancies are a sign of people switching jobs, rather than new jobs being created. At the same time, many have left the workforce for health, lifestyle or other reasons (the "Great Resignation"). Labor force participation – the share of the working-age population with a job or actively looking for work – is 1 percentage point below its pre-pandemic level. This is very much a U.S. problem. In Europe, the quit rate is lower, and furlough programs helped participation recover quickly.

How to solve for the reduced labor supply in the U.S.? Further wage growth could entice the unemployed to fill job openings and entice employees to stay in their current jobs, rather than quit in search of better pay. Vacancies could come down and employment could rise by 1.5 million, or 1% of the U.S. work force, we estimate. And unemployment may not fall much further if higher wages induce those who left the workforce during the pandemic to return.

The labor market dynamics reinforce our belief that we are in a world shaped by supply, not excess demand. We see inflation cooling from 40-year highs as the economy heals. But we're are not going back to the "lowflation" years before the pandemic, we believe, amid ongoing supply constraints. As a result, we expect the Fed to ultimately raise rates to a neutral level that neither stimulates nor decreases economic activity. Raising rates beyond neutral to try to squeeze out inflation even further would come at too high a cost to growth and employment, in our view. The result: We see the sum total of rate hikes at a historically low level given inflation. This reinforces our underweight to government bonds and overweight to equities. We favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe. The reason: We see the energy shock emanating from Russia's invasion of Ukraine hitting Europe hard.

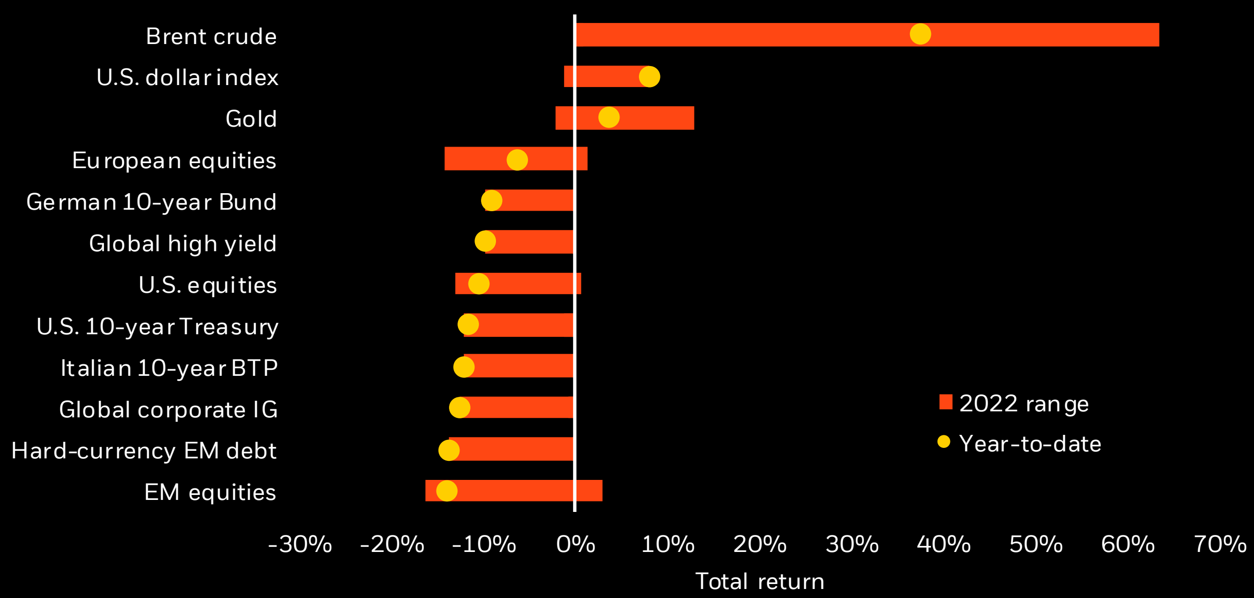
Bottom line: We do not see a wage-price spiral building. Private sector wages in the U.S. have increased, but what matters for companies is that real unit labor cost have actually fallen thanks in part to productivity gains. This means there's still room for wages to grow. Higher wages could help the U.S. labor market recover from pandemic-related worker shortages by encouraging people to return to the workforce or stay put in their jobs, rather than shopping around for more compensation.

Market backdrop

The S&P 500 plunged to new 2022 lows last week to clock its worst month since the pandemic's sell-off in March 2020. We believe stocks can do well in the inflationary backdrop - but acknowledge other mounting challenges such as the energy shock and China's growth slowdown. The U.S. economy unexpectedly contracted in the first quarter, but consumer and business spending showed strength. We believe the economic restart is still in full swing. See our *Macro insights*.

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 April 28, 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

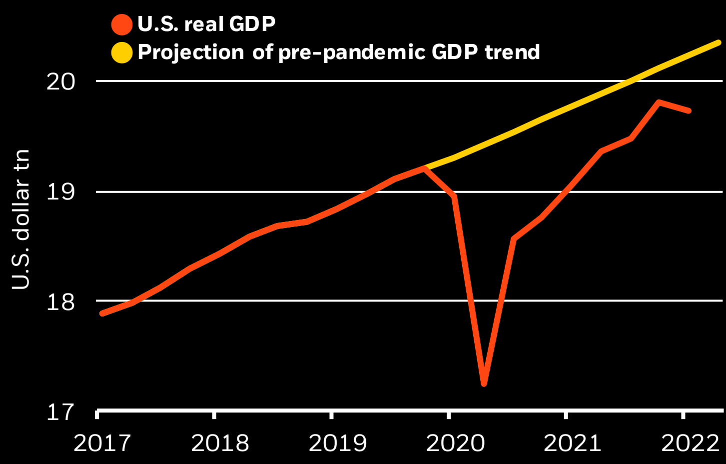
The U.S. economy shrank by 1.4% in the first quarter of 2022 - see the red line in the chart. This has fueled concerns that a recession could be around the corner. We don't think so. Key to remember: The post-pandemic restart of economic activity is not a typical business cycle recovery. It's more like rebuilding after a natural disaster. And we think the restart is not yet done.

Why? Consumer spending is still growing, driven entirely by services (spending on goods decreased slightly). The shift back to spending on services is a key indicator of a continuing restart. It's a reversal of the massive spending shift away from services and toward goods that followed the pandemic lockdowns. That dynamic created supply bottlenecks and pushed up prices. As it unwinds, we can expect those inflationary pressures to ease.

A further sign that the restart is not yet finished? U.S. GDP is still 2.5% below where it would have been without the pandemic (yellow line).This shows the economy still has room to grow. See our macro insights hub.

Not a recession warning

U.S. real GDP and pre-pandemic projection



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Refinitiv Datastream, April 2022. Note: The chart shows U.S. real GDP and a projection of what GDP might have been if it kept growing at its average pace from earlier quarters from Q4 2019 onward.

Investment themes

1 Living with inflation

- We expect central banks to quickly normalize policy. We see a higher risk of the Federal Reserve slamming the brakes on the economy to deal with supply-driven inflation after raising rates for the first time since the pandemic.
- The Fed has projected a large and rapid increase in rates over the next two years. 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 inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation. DM central banks have already demonstrated they are more tolerant of inflation.
- The Bank of England hiked rates for a third time but signaled that it may pause policy normalization on concerns about the growth outlook from spiraling energy costs. This is the bind other central banks will likely face this year.
- The European Central Bank has also struck a hawkish tone, planning to wind down asset purchases and leaving the door open for a rate increase later this year. We expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- **Investment implication**: We prefer equities over fixed income and overweight inflation-linked bonds.

2 Cutting through confusion

- We had thought the 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 saw the confusion play out with the aggressively 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 employment, and they can't cushion the growth shock.
- The sum total of expected rate hikes hasn't changed much, even with the Fed's hawkish shift.
- **Investment implication:** We have tweaked our risk exposure to favor equities at the expense of credit.

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 fossil fuels 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 DM equities over EM as we see them as better positioned in the green transition.

Week ahead

May 3	Euro area unemployment rate; U.S. factory orders	**May 5**	Bank of England policy decision; China services PMI
May 4	Fed policy decision	**May 6**	U.S. employment report; Japan CPI

The Fed is likely to raise its policy rate by 0.5% this week to 0.75-1%, while the Bank of England is poised to hike another 0.25%. Fed Chair Jerome Powell may reiterate his tough talk talk on reining in inflation. We think the Fed will quickly lift policy rates through 2022 but ultimately will re-assess before going beyond neutral levels that destroy growth and jobs.

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+2	+1	We increased our strategic equities overweight in the early 2022 selloff. We saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. 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 favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.
Credit	-1	-1	We are underweight credit on a strategic and tactical basis against a backdrop of rising interest rates and high valuations. We prefer to take risk in equities instead. Tactically, 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 given their diminished ability to act as portfolio diversifiers with yields near lower bounds. 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, April 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	+2	We overweight DM stocks amid supportive fundamentals, robust earnings and low real yields. We see many DM companies well positioned in the inflationary backdrop thanks to pricing power. We prefer the U.S. and Japan over Europe.
United States	+2	We overweight U.S. equities due to still strong earnings momentum. We see the Fed not fully delivering on its hawkish rate projections. We like the market's quality factor for its resiliency to a broad range of economic scenarios.
Europe	+1	We are moderately overweight European equities as we expect the energy shock to hit European growth hard. We like the market's cyclical bend in the inflationary backdrop and expect the ECB to only slowly normalize policy.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued and prefer other DM equities such as U.S. and Japanese stocks.
Japan	+2	We are overweight Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.
China	+1	We now see Chinese stocks as more risky, but improved valuations leave us moderately overweight. China's ties to Russia have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities and prefer DM equities, given more challenged restart dynamics, higher inflation pressures and tighter policies in EM.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China because of easing monetary and regulatory policy.
U.S. Treasuries	-1	We underweight U.S. Treasuries even as yields have surged this year. We see long-term yields move up further as investors demand a higher premium for holding governments bonds. We prefer short-maturity bonds instead.
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	-1	We underweight European government bonds. We see yields heading higher even as markets have adjusted to price in an end to negative rates and beyond.
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	+1	We overweight Chinese government bonds. Easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
Global investment grade	-1	We underweight investment grade credit amid tight spreads and interest rate risk. We see more value in equities instead.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive. We prefer to take risk in equities.
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	+1	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.

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