# Weekly commentary

July 11, 2022

BlackRock

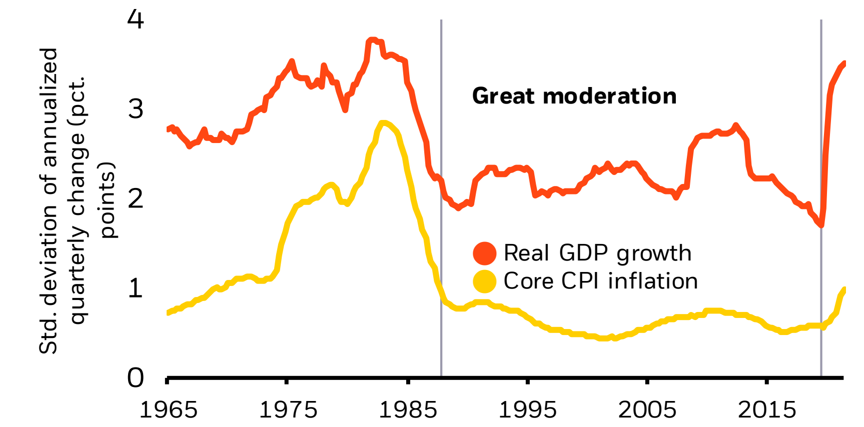
## Downgrading stocks, upgrading credit

- We see a new era of volatile inflation and growth sweeping aside a period of moderation. We downgrade equities and upgrade credit in this new regime.
- U.S. jobs data last Friday reinforced that the supply shock is causing persistent inflation. Yields resumed their rise as markets priced higher odds of rate hikes.
- U.S. inflation is in laser focus this week. Persistently high monthly inflation rates could cement the case for a 75-basis point Fed rate hike later this month.

We think the Great Moderation is over. What's replaced this era of steady growth and inflation? A new regime of increased macro volatility and higher risk premia. Central banks appear set on reining in inflation by crushing growth. We cut most developed market (DM) equities to a tactical underweight as a result, while we lean into credit. In strategic portfolios, we still prefer stocks over bonds. Why? We see policymakers ultimately living with some inflation. See our midyear outlook.

### The end of the Great Moderation

Volatility of U.S. GDP growth and core inflation




Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis and Labor Department, with data from Haver Analytics, March 2022. Notes: The chart shows the standard deviation of the annualized quarterly change of U.S. real GDP and the core Consumer Price Index.

What happened to the Great Moderation anyway? It got flipped upside down. Key features of the era were steadily expanding production capacity and demand shocks. Central banks could easily nudge spending by cutting or hiking rates. But now that's flipped (see chart). Why? Production constraints. The pandemic triggered a huge sectoral shift in spending from services to goods as well as labor shortages. The restart and war in Ukraine added an energy crunch. These are tough problems to solve. A pile-up of global debt to buffer the Covid shock limits the wiggle room of central banks – and makes it more tempting to live with inflation. And the politicization of everything means policy debates are oversimplified when nuanced solutions are needed. All this makes trade-offs between growth and inflation harder, we believe, and leads to worse outcomes.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BlackRock **Investment** Institute

Three investment themes guide us in the new era. First – *Bracing for volatility*. Macro volatility drives market volatility. The end of the Great Moderation is now causing fierce market gyrations. In this structurally more volatile environment, investors will demand higher risk premia, or compensation for holding both stocks and bonds. What do we think this means? Both tactical and strategic allocations have to adapt more quickly. Portfolios have to get more granular at the sector level. Traditional 60/40 stock-bond portfolios and models won't work as well anymore. And "buying the dip" is unlikely to be as effective as it was before. The inertia behind those kind of behavioral biases must be overcome, we believe.

Our second theme is as relevant as ever – *Living with inflation*. Right now, we think the Fed has boxed itself in by responding to political pressures to rein in inflation. In other words, the politics of inflation rule. This implies downside risks to growth and company earnings. Eventually, the damage to growth and jobs from fighting inflation will become obvious, in our view, and central banks will live with higher inflation. Production constraints rooted in the pandemic and exacerbated by the war in Ukraine have led to 40-year highs in inflation. The spike in commodities is a prime example of how these factors have collided into an inflation explosion. And we see an era of structurally higher commodities prices ahead.

The bumpy transition to net-zero emissions also fuels the new regime's volatility. This makes for our third theme - *Positioning for net zero*. We believe markets haven't fully priced in fast-changing societal preferences for sustainability and technological innovation. We like "already-green" companies and carbon-intensive ones with credible transition plans.

What does all this mean for portfolios? More frequent tactical changes – like spotting a turning point for stocks when markets eye a dovish pivot by central banks. In the short term, we've cut DM equities except Japanese stocks as central banks appear set to overtighten policy. We upgrade credit to overweight as part of an up-in-quality adjustment to portfolios. We still like inflation-linked bonds, and now prefer the euro area. And we like UK gilts as we see the Bank of England turning dovish.

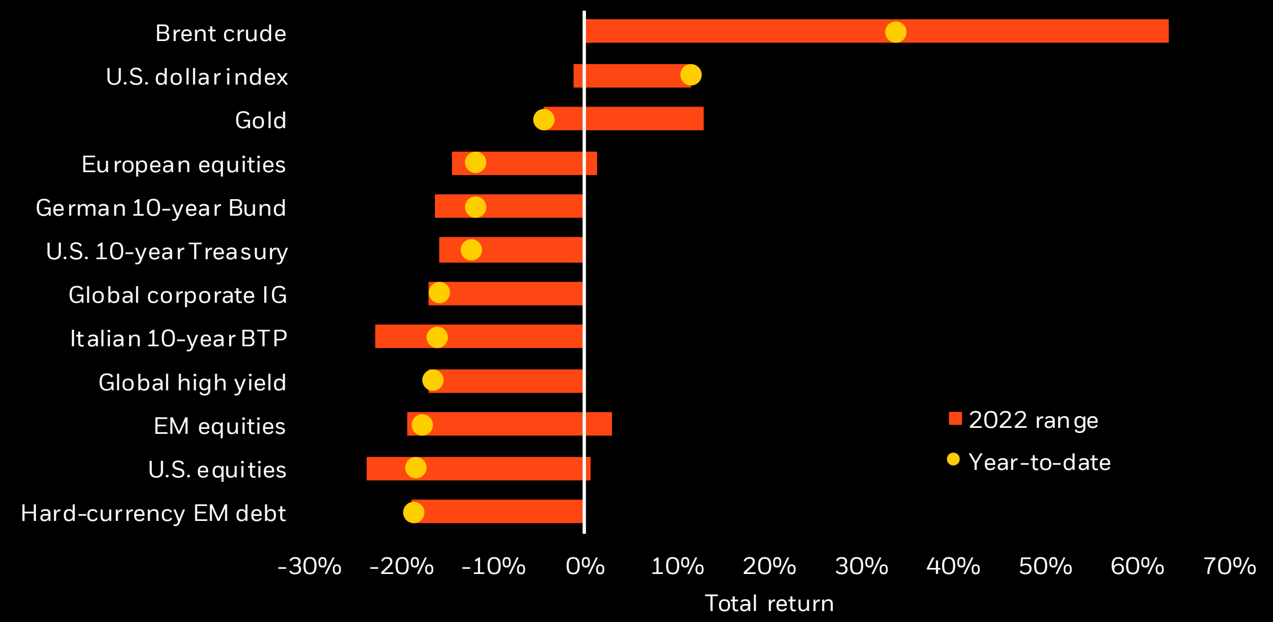
Strategically, we believe our stance is positioned for the new regime. We prefer equities over bonds in the long run as yields rise and inflation trends higher. We think central banks will live with higher inflation, pause and then change course on their rate rises– a boon for stocks. Private markets are not immune in this new regime of higher volatility but opportunities exist for selective investors, especially in private credit. See our full Midyear outlook for the granular changes to our asset views.

# Market backdrop

Last week's U.S. jobs update underscores the ongoing supply shock that will cause higher inflation to be more persistent. Non-farm payrolls were a little higher than expected, allowing for downward revisions in earlier months. But the participation rate – capturing those in or looking for work – fell on the month. Bond yields resumed their rise as markets priced in higher chances that the Fed will raise rates by 75-basis points at its policy meeting later this month.

## 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 July 7, 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.

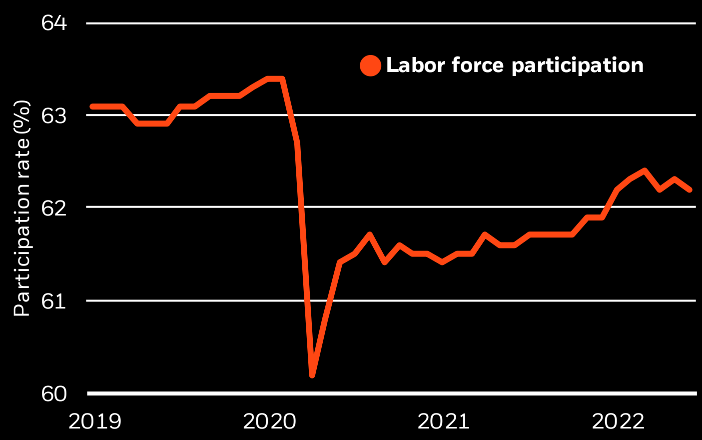
## Macro insights

Employers in the U.S. are currently finding it difficult to hire workers. That's partly because many people left the workforce altogether in the pandemic – meaning they're not just out of work, they're not looking either. Some were laid off, others had health concerns, some needed to care for children or relatives. As the orange line on the chart shows, many have since come back, but not all. In fact, U.S. payroll data released last week showed a slight dip in workforce participation. This highlights how difficult making up that remaining worker shortfall could be: data suggest there are around 1.7 million fewer people in, or looking for, work than would have been the case without the pandemic.

We believe higher wages could help entice more people back: real wages, or adjusted for inflation, have barely moved since the pandemic. Higher wages wouldn't necessarily create further inflation pressure if they continue simply keeping pace with inflation. In our view, this difficult labor situation is one of the key factors behind current high inflation – so how it evolves is key to the inflation outlook.

## Workers wanted

U.S. labor force participation, 2019-2022




Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Haver Analytics, July 2022. Note: The chart shows the share of the working-age population that is working or actively looking for work.

# 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 exacerbated by 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 also gives policymakers less manoeuvring 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 world shaped by supply unlike any we have seen in recent decades. Major spending shifts and production constraints are the driving force of inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns
- 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.
- The Bank of England warned of the poisonous combination of a 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 causing a recession. We expect the ECB to accept this at some point and rethink its rate path.
- We think the eventual sum total of rate hikes will be historically low given the level of inflation but brace for volatility.
- **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.
- 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
- 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

| | | | |
|---|---|---|---|
| **July 12** | Germany ZEW survey | **July 15** | U.S. University of Michigan Sentiment, China GDP |
| **July 13** | U.S. CPI inflation | **July 11-18** | China total social financing |

U.S. CPI will be key this week. A continuation of the pattern of persistently high monthly inflation rates would likely cement the case for a 75-basis point Fed hike later this month. We see the Fed continuing with hikes up to restrictive levels by the end of the year. In China, second quarter GDP will help gauge the economic impact of strict Covid lockdowns earlier this year.

# 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 | -1 | We are overweight equities in our strategic views of five years or longer. We expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we cut DM equities to underweight as central banks appear set to overtighten policy and we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins. |
| **Credit** | -1 | +1 | We are underweight publicly traded credit on a strategic basis and prefer to take risk in equities. Tactically, we upgraded credit to overweight given the jump in yields and credit spreads – and our view of contained default risk. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk. |
| **Govt bonds** | -1 | -1 | We are strategically underweight nominal government bonds, with a preference for short-dated maturities. We stay firmly underweight long-dated bonds as we see investors demanding higher compensation amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation. |
| **Private markets** | Neutral | — | We believe non-traditional return streams 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. We underweight private equity, favoring income assets such as private credit instead. Many institutional investors are 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** | -1 | We cut DM stocks to underweight 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 upgrade UK gilts to overweight. 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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