Weekly commentary

BlackRock

September 26, 2022

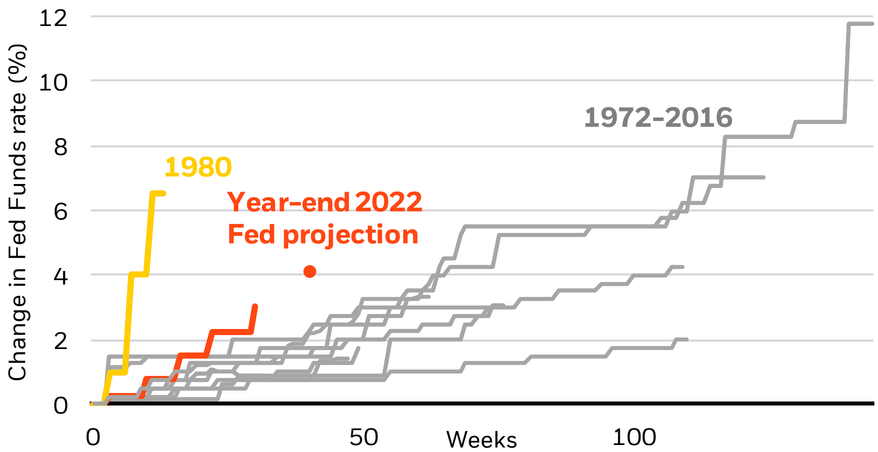
Sour Fed growth view not dour enough

- Many central banks aren't acknowledging the extent of recession needed to rapidly reduce inflation. Markets haven't priced that so we shun most stocks.
- Yields surged after more rate hikes and the UK's fiscal splurge news. We cut UK gilts to underweight as we see higher rates and fiscal credibility questions.
- U.S. and euro area inflation is likely to show persistence in data this week. We think central banks underestimate the cost of bringing it down to target quickly.

Many central banks, like the Fed, are still solely focused on pressure to quickly get core inflation back to 2% without fully acknowledging how much economic pain it will take in a world shaped by production constraints. Case in point: last week's rate-hike blitz. This all implies a clear sequence: overtighten policy first, significant economic damage second and then signs of inflation easing only many months later. We're tactically underweight developed market (DM) stocks and prefer credit.

Rapid rate rises

U.S. interest rate tightening cycles, 1972-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2022. Notes: The chart shows the speed of Federal Reserve hiking cycles since 1972. The yellow line shows the fastest cycle. The orange line shows the current cycle. The orange dot is the projected change in the fed funds by year-end 2022 since the start of the cycle.

The Federal Reserve is on its fastest rate hiking cycle since the early 1980s (see orange and yellow lines in chart). It hiked another 0.75% last week and projected rates would go even higher. The Fed now sees the fed funds rate rising to 4.6% by the end of 2023, a significant bump from prior views. The problem? Updated economic forecasts are too optimistic, in our view. The Fed still sees positive growth this year and sees it picking up next year. But it also wants to see evidence core inflation is on a decisive 2% trajectory beyond 2023 before it stops hiking. This soft landing doesn't add up to us. We think quashing inflation that quickly amid constrained production capacity would take a recession – a roughly 2% hit to economic activity and 3 million more unemployed. We think the Fed is not only underestimating the recession needed but ignoring that it's logically necessary.

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Why would a recession be needed to reduce core inflation? Unusually low supply can't meet demand. That's driving inflation. There are two reasons why. First, a labor shortage – people who left the workforce during the pandemic haven't returned yet. Second, the economy wasn't set up to match consumer spending's massive shift from services to goods that hasn't fully reversed even as the world moves on from the pandemic. Central banks can't fix these constraints, in our view, hence a brutal trade-off: trigger a deep recession by hiking rates or live with more persistent inflation. The Fed's forecasts don't acknowledge this trade-off. It reconciles this by assuming production constraints will rapidly dissolve, causing inflation to fall quickly. But if that's the outcome, what's the point of the fastest hiking cycle since former Fed Chair Paul Volcker's era?

The Bank of England (BoE) has been transparent that quickly pushing inflation down will require a recession. But the UK now faces different challenges that change fundamentally how we look at UK assets. The UK government revealed a fiscal splurge on Friday that effectively throws money at an inflation problem, in our view. After last week's hike, this means the BoE will have to hike more and leave rates elevated for longer than it planned to, we think. But more importantly, the fiscal splurge puts the UK's fiscal credibility into question. The plans follow measures to subsidize energy bills and amount overall to 10% of GDP over the next five years, we estimate. The pound cratered to a 37-year low against the dollar and gilt yields surged after the news. All of this will help motivate the BoE's hawkishness. That's why we've downgraded UK gilts to underweight.

The implications of all of this: We think central banks will keep raising rates until it's clear that core inflation is coming down. That means economic activity is set to fall across DMs. The Fed's current policy may drag down U.S. growth far more than it realizes. In Europe, we see the European Central Bank's resolve to push inflation down fraying as it wakes up to the bleak outlook. But that reaction will come too late to prevent the central bank from amplifying the energy shock's recessionary forces, in our view. The continent will see a deeper recession than in the U.S.

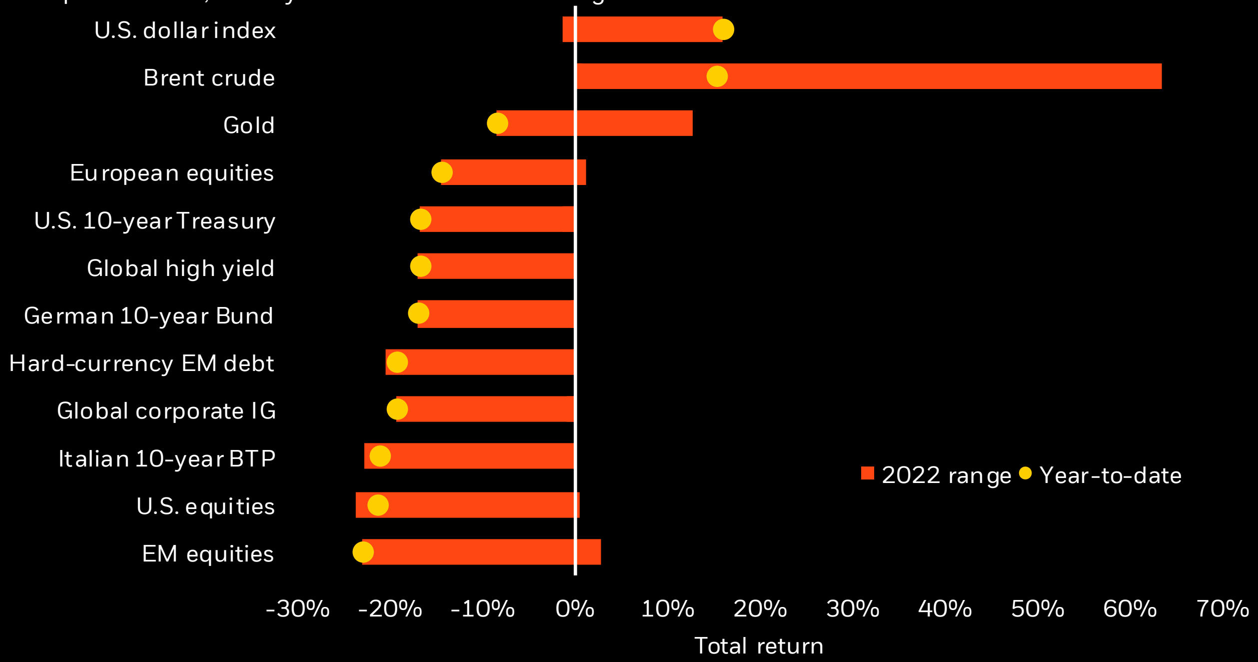
Our bottom line: We're tactically underweight DM equities as stocks aren't fully pricing in recession risks. We don't see a "soft landing" outcome where inflation returns to target quickly without crushing activity. That means more volatility and pressure on risk assets, we think. We prefer investment grade credit as yields better compensate for default risk. Plus, high quality credit can weather a recession better than stocks. We find inflation-linked bonds more attractive and stay cautious on long-term nominal government bonds amid persistent inflation.

Market backdrop

Stocks slid and yields surged after hawkish central bank actions. The Fed raised rate expectations into next year and revised growth and unemployment forecasts. We think they're too optimistic. The Bank of England also hiked. But a fiscal splurge may lead to even more hikes and poses risks of further rises in long-term yields and pound depreciation. Japan intervened for the first time since 1998 to prop up the yen. Bucking the trend, the Bank of Japan kept its yield curve control policy.

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. 22, 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

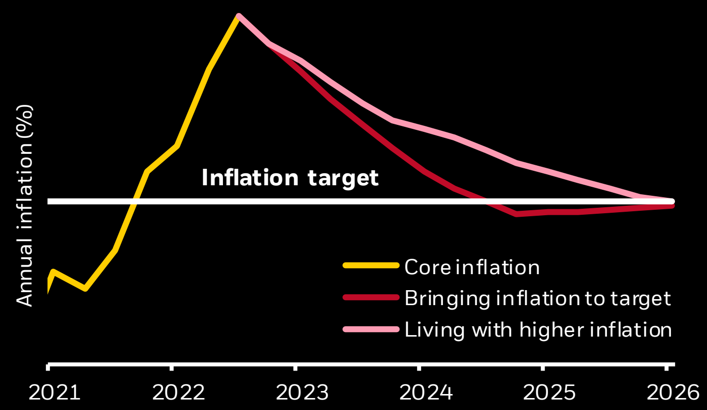
Where should central banks land on the inflation-growth trade-off? And what is the appropriate speed to bring inflation back down to the 2% target? These are crucial questions in the inflation debate that should be happening, Jean and Alex explain in our latest Macro Take .

Central banks could reduce the hit to growth by taking longer to bring inflation (see yellow line on chart) back to target instead of trying to wrestle it down quickly (dark red line). The gradual approach would give the economy a chance to find a new equilibrium as production capacity slowly recovers. The cost of that choice is inflation staying somewhat higher for longer (pink line). But if inflation expectations remain anchored, that could overall be a better outcome for society.

This is the most difficult economic environment to navigate in half a century. There's no desirable outcome at this stage – the question is which is the least bad. That's why it's time for a public debate. Read the full blog.

How fast should inflation come down?

Illustrative inflation scenarios, 2021-2026



Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, September 2022. Notes: The yellow line shows core inflation in a hypothetical economy. The dark red line shows a hypothetical path of inflation consistent with bringing it down to a 2% target by 2024, whereas the pink line shows an alternative path with it remaining above 2% until 2026.

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 0.75% a third-straight time in September and revised higher its projections for rate rises with the aim to rein in inflation. 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.
- After hiking rates again in September, the Bank of England (BoE) will likely have to hike more and leave rates higher for longer after the UK government revealed a fiscal splurge. The latest BoE minutes imply recession is in the cards earlier than expected this year and into 2023, partly due to the energy shock.
- The ECB announced a record 0.75% rate hike in September and cut its growth forecasts. The ECB's forecasts show it is still underappreciating the energy crunch's hit to growth, in our view. We expect the ECB to keep raising rates through this year but then stop once it sees the scale of economic damage caused by the energy crisis and hikes.
- **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. 27	U.S. consumer confidence and durable goods	**Sept. 30**	U.S. PCE and Euro area HICP inflation; China PMI; UK GDP
Sept. 29	Bank of Mexico policy decision		

We're watching inflation data in the U.S. and the euro area, including the Fed's preferred PCE metric. For now, the Fed only seems to care about evidence inflation is decisively on a path toward its 2% target. The assessment of U.S. consumers will show if they agree with Fed forecasts that the economy can avoid recession. We think the Fed is underappreciating the economic damage needed to bring inflation down quickly to target. We see persistent inflation and recession next year in the U.S.

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 reduce UK gilts to underweight following the UK government's fiscal splurge. The Bank of England will need to hike rates higher to rein in price pressures, and we believe the move raises serious questions about the UK's fiscal credibility.
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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