Weekly commentary

November 14, 2022

BlackRock

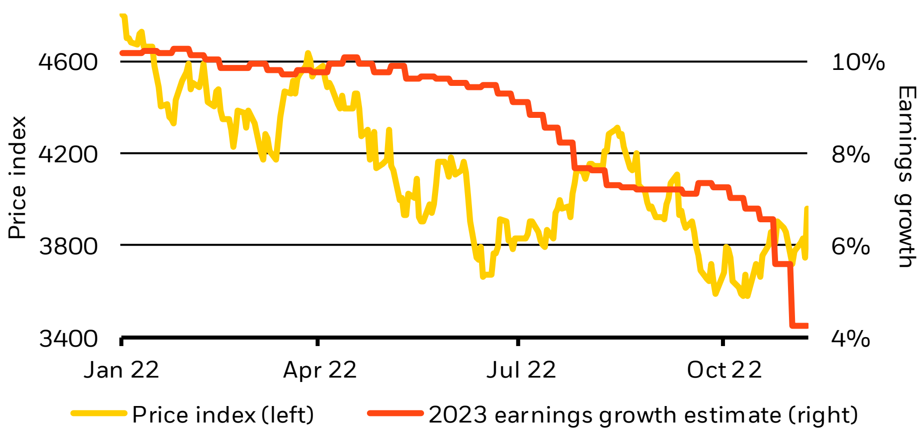
Stock surge to meet recession reality

- Surging stocks show markets believe hopes of a soft landing by the Fed to be true. We disagree and stay underweight developed market (DM) stocks.
- U.S. stocks jumped and bond yields plunged after October CPI rose less than the market expected. But sticky core inflation keeps the Fed on track to overtighten.
- We're watching UK unemployment, CPI and the fiscal update. The data may show more signs the UK is falling into a recession with inflation staying high.

One economic release overshadowed the U.S. midterms for markets. Stocks surged last week after the October core CPI rose less than expected, stoking market hopes a Federal Reserve pause on rate hikes is nearer. That's optimistic, we think. Goods inflation is easing as it needed to, but the labor constraints driving wage growth and core inflation persist. So the Fed is still on a path to create a recession via policy overtightening. Stocks aren't pricing that in, so we stay underweight.

Stocks and earnings expectations part ways

S&P 500 price and 2023 earnings growth estimates



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Nov. 10, 2022. Notes: The chart shows the S&P 500 price index (yellow line) versus analysts' earnings growth estimates for 2023 (orange line) since the start of 2022.

Equities have repeatedly jumped this year on hopes the Fed may be getting closer to stopping the fastest hiking cycle since the 1980s, letting the economy enjoy a soft landing that avoids recession. We think those hopes will be dashed again as the Fed pushes ahead with policy overtightening. With the S&P 500 jumping 13% from its October low, stocks are even further from pricing in the recession – and earnings downgrades – we see ahead. See the yellow line in the chart. Earnings estimates are set to be downgraded further. The consensus expects earnings growth of just over 4% in 2023, down from about 10% at the start of 2022 (orange line). We expect zero growth. Third quarter annual earnings growth would already be negative without the energy sector, Refinitiv data show. We need to see stocks fall more or more good news of easing inflation to turn positive on stocks.

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The slower rise in core CPI inflation, which excludes volatile food and energy prices, due to falling core goods inflation is good news. We'd expected this to happen at some point as spending patterns normalize after the pandemic, when a sharp shift in consumer spending toward goods and away from services drove the initial spurt of goods inflation. Spending is starting to return to services, easing supply constraints on goods. We expect declining goods inflation to continue. But high core inflation also reflects constraints on labor supply that are driving up wages, seen in services inflation. We don't expect this to improve much because many workers retired during the pandemic. We also see the U.S. labor pool shrinking as people over 65 account for a larger share of the population in coming decades.

The Fed can only try to push wage and overall core inflation quickly down to its 2% target by crushing demand with a deep recession, in our view. We expect the Fed to pause its sharp hikes only after having caused a recession and when confronted with the economic pain. We don't think a soft landing is in the cards. Yet it took just one downside surprise in CPI – one data release, not a trend – to revive hopes that the Fed would stop hiking soon and a soft landing could still be achieved. That helped to quickly wipe the U.S. midterm election – the original subject of this week's commentary – from the market's mind. This is a good reminder that in this new regime of higher macro and market volatility, we should not be surprised by surprising data. We think the Fed's "whatever it takes" approach to bringing down inflation means that no single data release or catalyst is about to change the Fed's path to overtighten policy.

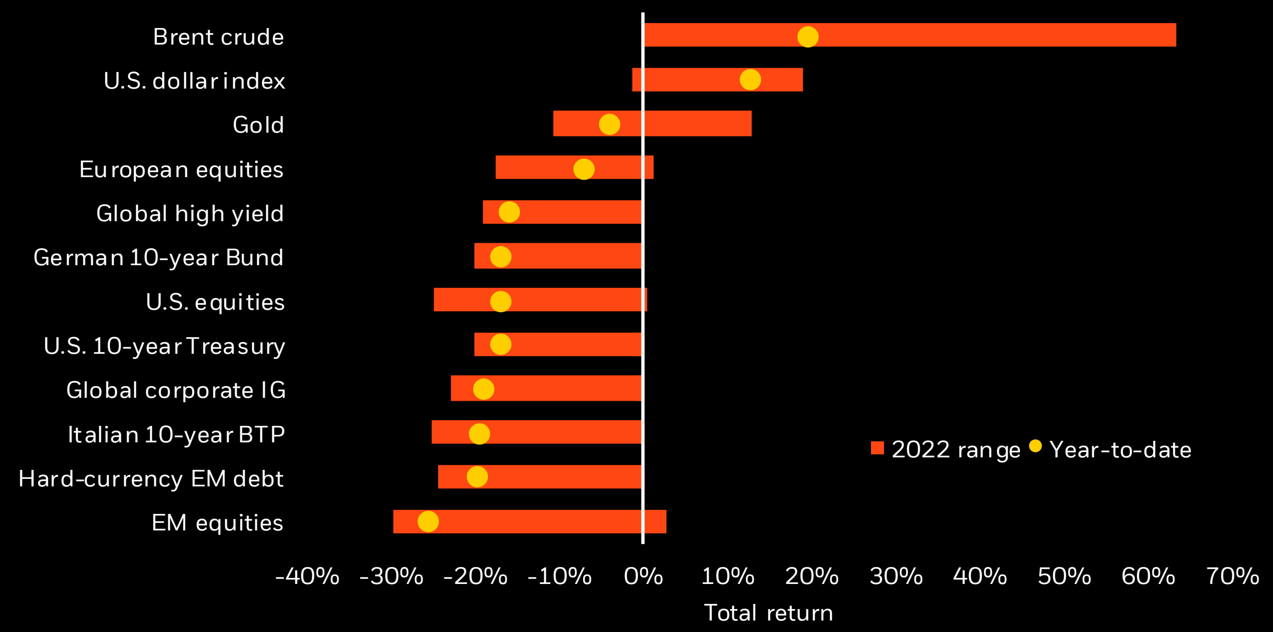
Our bottom line: We're tactically underweight DM stocks, including the U.S., because they're even further away from pricing in recession after last week's surge. But we think some sectors like energy, financials and healthcare allow us to take advantage of thematic, near-term and structural trends. Landmark U.S. legislation over the past year, like the Inflation Reduction Act, has brightened the outlook for renewable energy and the industrial sector. Earnings for traditional energy are still strong given ongoing supply shortages. Healthcare is a favorite of investors looking for shelter as recession looms given its stable cashflows in economic downturns and attractive valuations. The sector will also benefit as an aging world population ramps up medical spending. Lastly, deposit rates not rising as much as policy rates has boosted bank earnings, making their income from lending greater than the amount paid on deposits. We believe the new regime warrants a granular approach as themes like production constraints, dollar strength and geopolitical fragmentation are better implemented through sectors.

Market backdrop

U.S. stocks surged and Treasury yields fell sharply after the core October CPI rose a lower-than-expected 0.3%. We think this is finally an encouraging development on inflation but doesn't yet change the overall picture. Core goods prices declined. But core services inflation remains sticky. We don't think one data release will change the Federal Reserve's path to overtightening policy – and think it would need to see more sustained signs of core inflation slowing.

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 Nov. 10, 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.

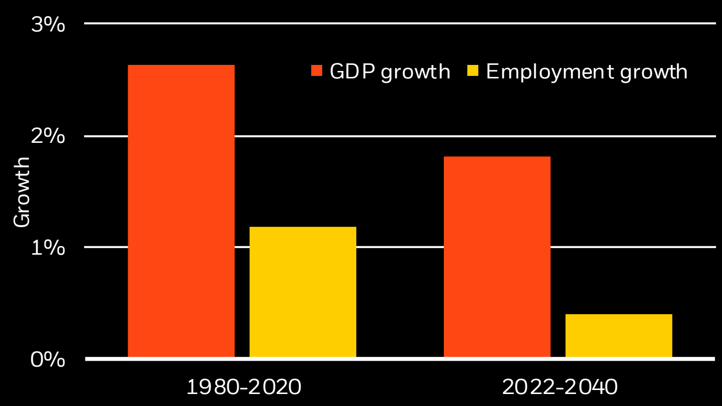
Macro take

The U.S. population is growing more slowly – and it's aging. An ever-increasing share of adults are over 64, the age at which most people typically retire. That, combined with the pandemic, has created a worker shortage – a key reason why U.S. inflation is so high right now and central to the difficult choice facing the Fed. Getting inflation down to target means reducing economic activity to a level that can more comfortably be sustained. In other words, a recession.

The worker shortage is also central to the future evolution of the U.S. economy. Demographic trends mean the available workforce will expand much more slowly in the coming 20 years than it did in the past 20. If the productivity of each worker continues to increase at the same rate, annual GDP growth could average around 1.8% in the future, compared to 2.6% in the past. See the chart. That's significant: The U.S. economy has never grown that slowly over a 20-year period since data began in 1920. It's also not a problem unique to the U.S. Read more in our latest macro take.

Worker shortage = slower growth

Actual and forecast employment and GDP growth, 1980-2040



Source: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, November 2022. Notes: The chart shows actual and forecasted employment and GDP growth.

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:** We are 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 energy shock and China's lockdowns.
- We are in a new macro regime where central banks are causing recessions rather than coming to the rescue. That is clear in the rate path of major central banks set to overtighten policy as they battle inflation. We think they will eventually pause but not cut rates when confronted with the damage of sharp rate hikes – that could be the reality of recession or the appearance of financial cracks, as seen in the UK.
- The Federal Reserve delivered another mega rate hike, as expected, but also signaled it would have to take rates higher than it originally planned, even if at a slower pace.
- The Bank of England has acknowledged some recession is necessary to get inflation down, yet like other central banks, it is failing to acknowledge the scale of the recession needed to get it all the way down to target.
- The ECB continues to normalize monetary policy, but a change in tone suggests it could be poised to slow the pace of hikes. We think the ECB is still raising rates into a recession triggered by the energy shock and its hikes.
- **Investment implication**: We are tactically underweight 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

Nov. 15	UK unemployment; euro area GDP; U.S manufacturing PPI
Nov. 16	UK CPI; U.S. industrial production
Nov. 17	UK fiscal statement; U.S. Philly Fed Business Index; Japan CPI

The UK takes center stage this week with unemployment and CPI inflation data, as well as the announcement of the much-anticipated fiscal statement from the new government. The UK fiscal update will factor into the Bank of England policy tightening plans depending on the size and timing of any austerity unveiled as the UK heads for a deep recession.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 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 think markets are underappreciating the persistence of high inflation and the implications for investors demanding a higher term premium. 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, November 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 prospects.
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. Attractive carry spurs a preference for short-maturity bonds.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. The pullback in euro area breakeven rates since May suggests markets are underappreciating the inflationary pressures from the energy shock.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	Neutral	We are neutral UK gilts. Perceptions of fiscal credibility have improved, though not fully, after a reversal of planned fiscal stimulus. We think the BoE will have to hike rates less than we assumed immediately after the Sept. 23 "mini budget."
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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