

Weekly commentary

November 28, 2022

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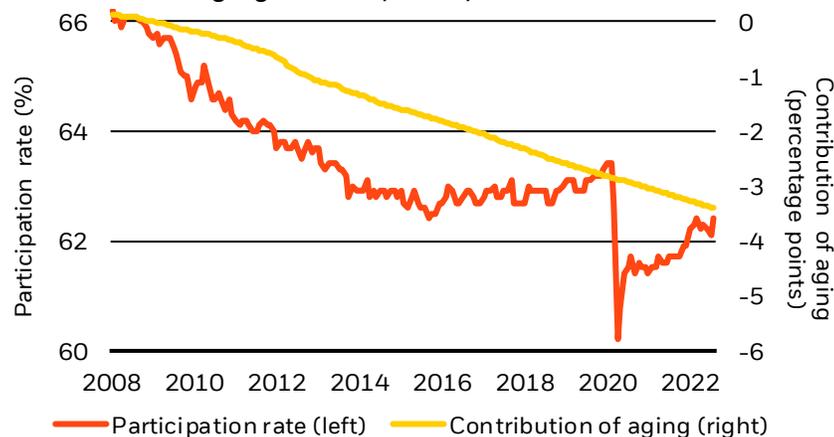
Aging raises cost of curbing inflation

- Aging has worsened labor shortages, raising the cost of taming inflation. We see the Federal Reserve living with some inflation, so we like inflation-linked bonds.
- Stocks edged higher, rallying 15% from October lows. They aren't reflecting the recession we expect. The yield curve remains deeply inverted.
- Labor supply is a major factor in determining the recession cost of trying to tame inflation. That's why this week's jobs data are key for the Fed and markets.

The share of the U.S. population in work or seeking a job is still below pre-Covid levels. This shortfall won't be made up: A bigger share of people are older than the normal retirement age – a major constraint. That makes it hard for the economy to operate at current activity levels without fueling inflation. The Fed would need to crush activity to push inflation back to its target. We see the Fed causing recession, with persistent inflation. We're underweight stocks and like inflation-linked bonds.

Aging behind workforce decline

Contribution of aging to fall in participation rate, 2008-2022



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, October 2022. Notes: The orange line shows the U.S. labor force participation rate, defined as the share of the adult population (aged 16 and over) that is in work or actively looking for work. The yellow line shows how much the aging population has contributed to the participation rate decline since 2008, as calculated by fixing participation rates and changing the weights based on population data.

A smaller share of the U.S. population is in the workforce than pre-Covid. That's unlikely to change, we think. Why? The participation rate, or the share of people aged 16 and over that have or are looking for work, nosedived when the pandemic hit and people left the workforce (orange line in chart). Some of that sharp decline has been made up as people return. But we don't see it recovering further because the effects of an aging population account for most of the remaining shortfall. More people have hit 64 years old, the age at which most retire. That's taken 1.3 million out of the workforce as of October, we find. Another 630,000 left as the pandemic caused fewer people to work past retirement age and hastened retirement for people coming up to 64. An aging population is increasingly cutting into the participation rate (yellow line) and shrinking the labor force.



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These trends explain why the U.S. participation rate is below its pre-Covid level and yet unemployment is still at a 50-year low. The share of the population aged over 64 has been increasing since 2010 and it's set to keep rising. The effect of this demographic shift on participation won't reverse without massive structural changes in workforce behavior over time, in our view. That implies the workforce will keep shrinking relative to the population. Economic activity will need to run at a lower level to avoid persistent wage and price inflation, especially in the labor-heavy services sector, in our view.

Interest rate hikes can't cure production constraints like labor shortages. So the Fed today faces a sharp trade-off between either creating a recession to slam economic activity down to levels that the economy can more comfortably sustain or living with more persistent inflation. For now, the Fed seems to be trying to do the first, we think, with its "whatever it takes" stance trying to quickly stomp inflation down to its 2% target. In the face of production constraints, bringing inflation down to target would require a deep recession, in our view – a roughly 2% hit to activity. That's why we think a recession is foretold. Yet we think the Fed will ultimately stop as the damage from rate hikes becomes clearer and before generating a deep recession. We think that means the U.S. will be in a recession and still living with inflation persistently above target.

An aging population will hurt the U.S. economy's ability to grow without creating inflation longer term. A lower birth rate may eventually offset some of that effect as household formation and housing demand fall – but only after the costs tied to the aging baby boom generation play out. Demographic trends also suggest the labor pool will expand much more slowly in the next 20 years than it did in the past 20. If individual worker productivity keeps rising at the same rate, annual GDP growth would average just 1.8% – about two-thirds the average from 1980-2020 and the slowest 20-year period since data began.

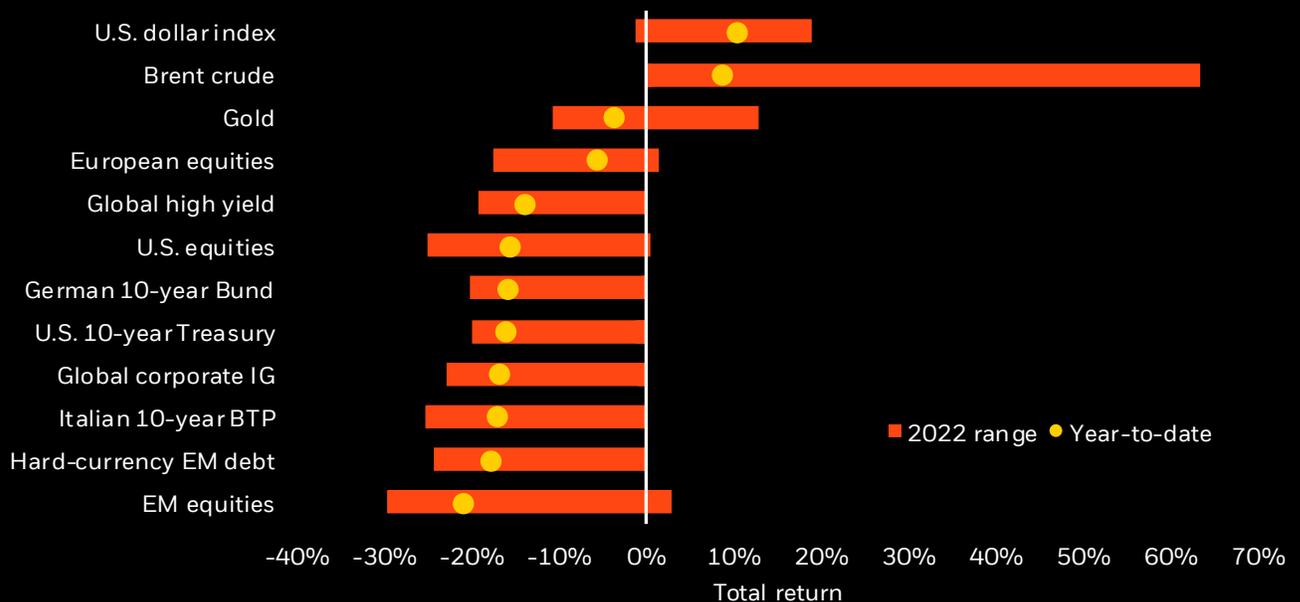
We stay overweight inflation-linked bonds because we think inflation will ease up but still be above the Fed's target for some time. We're underweight U.S. stocks in the short term because they haven't fully priced in the recession and corporate earnings downgrades we expect, especially as margin pressures mount from higher wages due in part to labor shortages. We're also underweight Treasuries – long-term bond yields don't reflect inflation's persistence or that investors will demand more compensation for holding them as a result. We instead prefer attractive income in short-end bonds and high-quality credit. Long term, we're overweight equities and think stocks' overall return will surpass fixed income. Watch for our 2023 Global Outlook, out on Nov. 30, for more details on our views.

Market backdrop

U.S. stocks edged higher last week, having rallied 15% from October lows. Long-term U.S. Treasury yields fell, causing the yield curve to invert by the most since the early 1980s. We don't think stocks are fully pricing in the recession we see from the Fed overtightening policy, even as U.S. PMI data confirmed a deeper contraction in activity. We think the Fed will eventually stop its rate hikes next year, but we're not expecting the swift rate cuts that the market is pricing in.

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. 24, 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

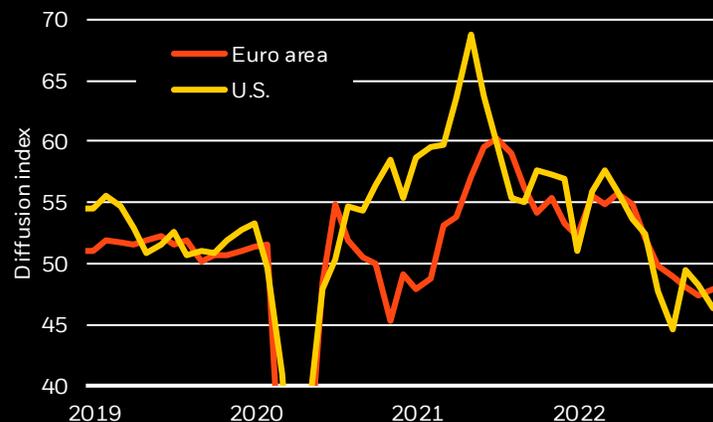
Economic activity is continuing to slow in the U.S., the euro area and beyond, according to the flash Purchasing Managers' Index for November. See the chart.

In the U.S., services activity has been contracting for a while but manufacturing activity also contracted this month for the first time since 2020, falling to a level previously seen only in recessions. Activity in the euro area was a little better than expected, partly because fears of gas rationing in Germany have eased somewhat. But it's still the fifth straight month of declining factory activity.

That's clear evidence that the damage from central banks' rapid rate hikes is starting to build, we think. Central banks are deliberately engineering recession in a bid to tame inflation. The ultimate size of the damage depends on how far they go: We expect them to stop hiking in early 2023, even though inflation won't be on track to get all the way down to their 2% targets. The result? Recession and persistently above-target inflation. Read all our latest blog posts [here](#).

Damage starts to emerge

Composite headline PMIs, 2019–2022



Source: BlackRock Investment Institute and S&P Global, with data from Haver Analytics, November 2022. Notes: The chart shows the composite PMI indicator, which is a survey-based measure of activity in both manufacturing and services sectors. Values below 50 indicate a contraction in activity.

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 and is still talking tough on rate 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. 29 U.S. consumer confidence

Dec. 1 Euro area unemployment; U.S. PCE

Nov. 30 Euro area inflation; U.S. job openings

Dec. 2 U.S. payrolls report

We're watching the U.S. labor market this week as worker shortages are a key production constraint. Euro area inflation and unemployment data are also important given the European Central Bank's latest hawkish rhetoric. Inflation remains stubbornly high, so we see the ECB pushing ahead with higher rates even as the economic damage becomes clearer.

Directional views

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

Asset	Strategic view	Tactical view
Equities	<p>+1</p>	<p>-1</p> <p>We are overweight equities in our strategic views as we see central banks ultimately choosing to live with some inflation. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks look set to overtighten policy – we see recessions looming. Corporate earnings expectations have yet to fully reflect even a modest recession.</p>
Credit	<p>+2</p>	<p>+1</p> <p>Strategically, we are overweight global investment grade on attractive valuations and income potential given higher yields. We are neutral high yield as we see the asset class more vulnerable to recession risks. Tactically, we're also overweight investment grade and 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.</p>
Govt bonds	<p>-1</p>	<p>-1</p> <p>The 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 underweight long-dated DM government bonds as we see term premium driving yields higher, yet we are neutral short-dated government bonds as we see a likely peak in pricing of policy rates. The high yields offer relatively attractive income opportunities.</p>
Private markets	<p>-1</p>	<p>—</p> <p>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.</p>

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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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