Weekly commentary

September 12, 2022

BlackRock

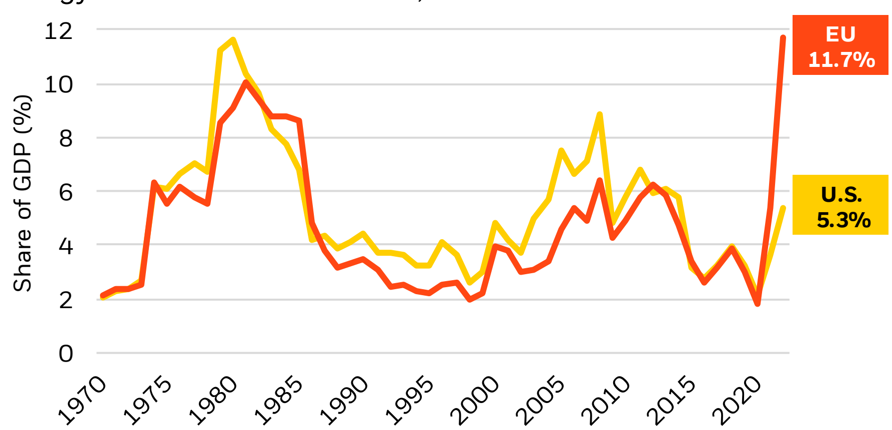
Energy shock spurs Europe's recession

- We think the energy crisis will spur a recession in Europe. The ECB is trying to fight inflation without recognizing the costs. We prefer credit over equities.
- The ECB raised rates by a record 0.75%. We think the ECB will keep raising rates through year-end until the economic effects of the energy crunch are clear.
- All eyes are on U.S. CPI inflation for signs of further easing, especially core inflation. We expect inflation to cool but still settle above pre-Covid levels.

The energy crunch will drive a recession in Europe, as we've argued since March. The crisis has worsened since then as Russia has halted gas supplies. Plus, the European Central Bank (ECB) isn't acknowledging how it will crush activity further by trying to fight high inflation, in our view. We think the ECB will wake up to this reality sooner than markets expect – but not before it inevitably faces a severe recession. We remain underweight equities and prefer high-quality credit.

Europe's energy squeeze

Energy burden as a share of GDP, 1970-2022



Sources: BlackRock Investment Institute and BP Statistical Review of World Energy 2021, with data from Haver Analytics. September 2022. Notes: The chart shows the cost of oil, gas and coal consumption in the European Union and U.S. as a share of GDP. We use regional energy prices and divide by GDP in U.S. dollars. Data for 2022 are based on IMF's latest GDP forecasts and the year-to-date average of daily commodities prices.

Europe's efforts to wean itself off Russian energy have triggered a price surge that's been amplified as Russia cuts gas supplies. The European Union is now spending nearly 12% of its GDP on energy, making the crisis worse than the 1970s oil shocks. See orange line in the chart. That's not the case for the U.S, a net energy exporter (yellow line). It's hard to see any relief for Europe in the next couple of years, with rationing on the horizon, in our view. Winter may cause demand to surge, slashing stockpiles. Countries are rushing to cushion pressure, especially on households. Germany plans to collect excess profits from energy providers and cap prices. EU energy ministers have called for similar policies. The UK has a sizable plan to pay energy suppliers the difference between a new capped price and the price they would have been able to charge.

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The euro area policies are much smaller than those in the UK or for Covid-19. That reinforces why the energy shock will drive a protracted recession lasting several quarters in Europe, in our view. The ECB is set to make things worse: Like the Federal Reserve, the ECB hasn't acknowledged the damage it must do to growth to fight this inflation, even after it hiked a record 0.75% last week. The ECB is instead responding to the politics of energy-driven headline inflation, we think. Its new forecast for modest growth next year is already stale by not accounting for recent events like Russia cutting off gas supply. We see the ECB's downside scenario of a -0.9% contraction as more likely. The euro sliding to 20-year lows against the U.S. dollar reflects deteriorating growth and terms of trade from higher energy prices, in our view.

The ECB will also have to contend with fragmentation risks – and perhaps put into practice its anti-fragmentation tool for peripheral debt spreads. Italy's economic fundamentals have worsened in this shock, with the shift to a current account deficit amid its heavy debt burden. That's more likely to feed volatility for Italian bonds, even if the coming election likely results in a center-right government that won't be very antagonistic to the EU.

We think the ECB will keep up its aggressive rate hikes through the end of 2022 but then stop once it sees the economy taking a major hit. Year-end rates will likely stand somewhat short of current market rate expectations, in our view.

Unlike others, the Bank of England (BoE) has been clear that bringing inflation down to target would require a deep recession. The UK's fiscal plans wouldn't change that, in our view. The measures are just another example of governments responding to the politics of high inflation. The subsidies may slow headline inflation and cushion the recession blow in the near term. But they can't solve the imbalance of low supply relative to demand – and in fact block the fall in demand required to reduce inflation. Limiting the hit to real household incomes reduces the growth drag the BoE would have expected. That implies the BoE will keep hiking rates to get demand back in line with supply but not as much as markets expect, in our view.

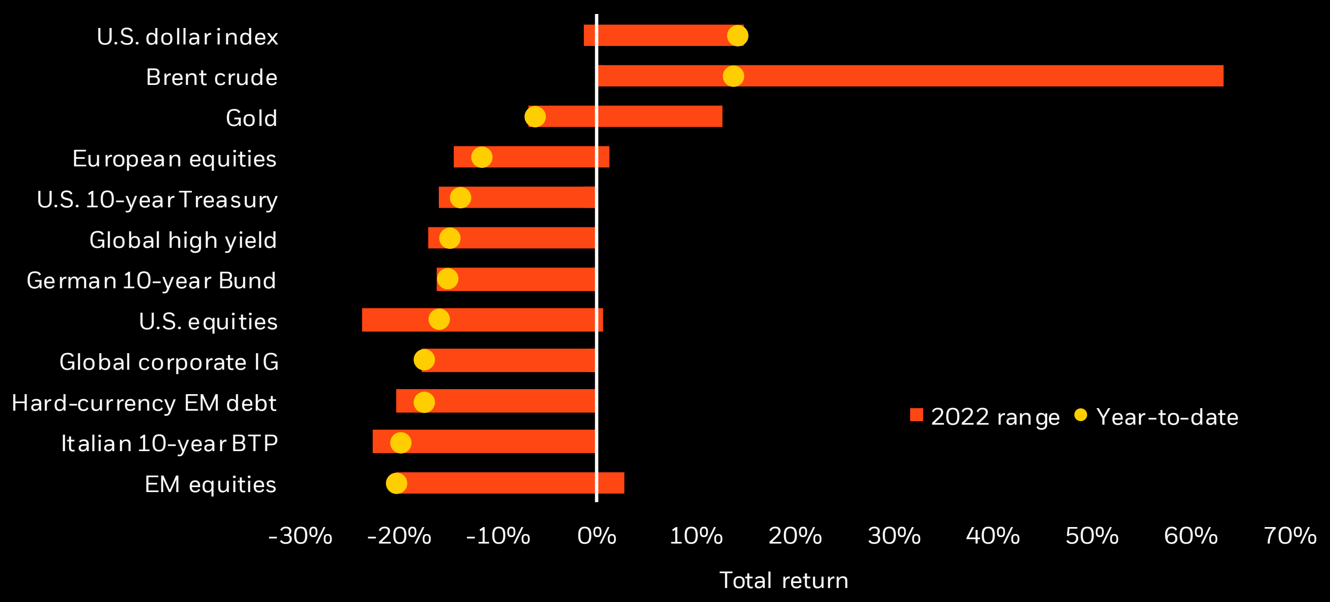
Our bottom line: European stocks aren't priced for the deep recession we expect. Excluding commodities, European earnings growth estimates are too optimistic, we think. We stay underweight European and most developed market stocks. We prefer investment grade credit as yields better compensate for default risk. We're neutral European government bonds and have a modest overweight to UK gilts with a preference for short-dated bonds due to markets pricing in an overly hawkish rate path.

Market backdrop

Volatility persists across markets – underscoring the new regime of heightened macro volatility. The ECB hiked rates a record 0.75% and cut its growth forecasts last week. Yet the ECB's new growth forecasts still don't reflect the deep recession we expect from the energy shock and higher rates. We see the ECB jacking up rates through year-end but then stopping as the economic toll from the energy shock and rate hikes becomes clear.

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. 8, 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

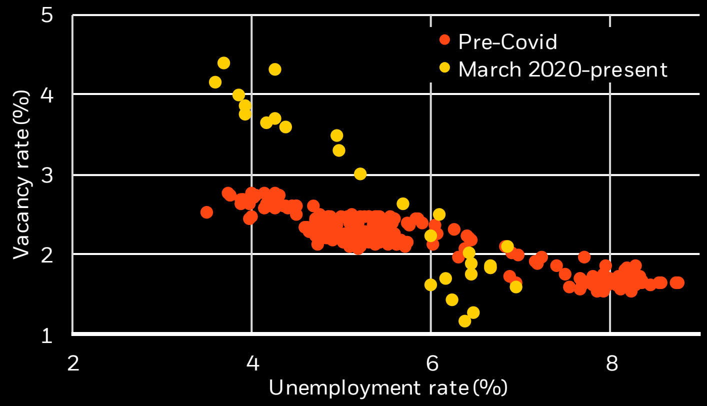
In our most recent Macro take, we estimate the level of activity the UK economy can comfortably sustain to be 5-6% lower now than it would have been without the pandemic. The UK's production problems stem mainly from low labor supply. The workforce has effectively dropped by about 2 million people, or 6%, based on our estimate of production capacity. Three forces are at play:

First, people of working age have decided to leave the labor force. The BoE expects more to do so over time. Second, there are fewer people of working age now versus what would have been expected based on pre-pandemic trends. And third, companies are finding it hard to fill vacancies from the pool of unemployed. As the chart shows, the number of unfilled vacancies is unusually high. We think companies are struggling to find a match between those who want a job and the skills they need.

The BoE can't do anything about labor supply. It is being honest that, given these constraints, it has to choose either recession or persistent inflation. Read the full blog here.

UK's persistent production problem

UK unemployment rate vs. job vacancy rate



Sources: BlackRock Investment Institute, UK Office for National Statistics, with data from Haver Analytics, September 2022. Notes: The chart shows the vacancy rate and unemployment rate for the UK using three-month rolling averages of monthly labor market data. The vacancy rate is defined as the number of vacancies divided by the sum of employment and number of vacancies. The unemployment rate is adjusted for March 2020-September 2021 in line with assumptions from the Bank of England, that 10% of those on furlough in each month were 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 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 another 0.75% in July and reaffirmed projections of more rate rises with the aim to rein in inflation. At Jackson Hole, Fed Chair Jerome Powell emphasized that the inflation objective is "unconditional." 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.
- The Bank of England raised rates to 1.75% in August. It also acknowledged the growth-inflation trade-off. It now sees a protracted recession through 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. 12	UK GDP data	**Sept. 14**	UK CPI data
Sept. 13	U.S. CPI data	**Sept. 16**	China retail sales; U.S. University of Michigan survey

The focus this week is on whether U.S. core inflation is slowing further or staying at elevated levels. The consensus sees the core CPI holding fairly steady, propped up by shelter costs, even if headline inflation likely cools on lower gasoline prices. The Bank of England policy meeting previously set for Sept. 15 has been rescheduled after Queen Elizabeth's death.

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 are overweight UK gilts. 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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