Weekly commentary

BlackRock.

September 19, 2022

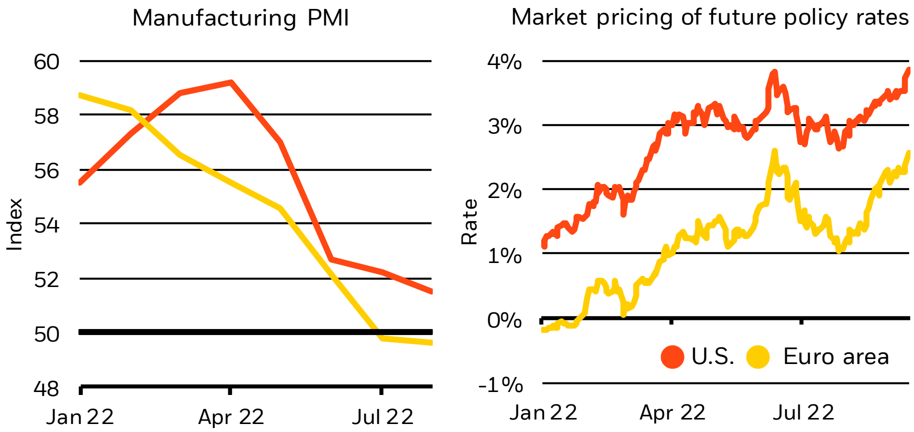
Sticking with reduced risk taking

- The new regime of macro volatility is playing out with weaker growth, persistent inflation and volatile markets. We stick with our dialed-down risk stance.
- U.S. stocks slumped and yields surged on a renewed rise in core inflation. We've argued inflation will be persistent and see the Fed hiking through year-end.
- Central banks are the main attraction this week. The Fed and the Bank of England are set to hike rates again. We see the Fed hiking 0.75% a third time.

The new regime of macro volatility is playing out. Business activity is slumping and higher inflation persists. Central banks are responding with aggressive rate hikes without fully acknowledging the growth damage required. Expected policy rates have jumped further since we downgraded developed market (DM) stocks in July – and recession risks still aren't factored in. We reaffirm our reduced risk taking stance in our tactical views and favor credit over stocks.

Weak growth, higher rates: a tough combo

Manufacturing PMIs and policy rate pricing, 2022



Sources: BlackRock Investment Institute, with data from S&P and Refinitiv Datastream, September 2022. Notes: the left chart shows S&P Manufacturing Purchasing Managers' Indexes - a value below 50 indicates contracting activity. The right chart shows the pricing of expected central bank policy rates via forward overnight index swaps. The rate shown is the one-year OIS rate expected starting one year from now.

Business activity is already stalling in the U.S. and Europe, as business surveys show (left chart). Yet the Federal Reserve and the European Central Bank (ECB) are expected to hike rates aggressively with a singular focus on fighting inflation (right chart). Last week's U.S. CPI report confirmed why we don't see a soft landing for the economy: inflation is proving sticky as we expected, and central banks are following a whatever-it-takes approach to inflation. This suggests they will overreact to upside inflation surprises but not necessarily respond to downside surprises. The upshot? We expect a policy overtightening that causes recessions. Our whole portfolio approach prompts us to reaffirm our tactical views taking reduced risk. We favor credit given our view that a major default cycle is unlikely and are underweight DM equities given the recession hit we see ahead.

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Our investment views had already been based on a mild recession in the U.S. and a deeper one in Europe given the energy crunch – but we don't think risk assets have come to terms with the combination of deteriorating activity and central banks pushing up rates more quickly. These developments prompt us to stick with our tactical positioning.

Our relative preference for high quality credit over equities still holds because of one big aspect: valuation. Higher spreads and government bond yields push up expected returns. And strong balance sheets imply investment grade credit could weather a recession better than stocks. We like investment grade credit, especially with short maturities, over high yield. This reflects our preference to be up in quality amid a worsening macro backdrop.

We're underweight most DM equities for now. We haven't bought the dips all year. The combination of an imminent recession and higher rates is still not fully reflected in equity valuations, in our view. If and when both of these are factored in – we would tilt back to neutral on stocks and start to consider signposts to turn more positive.

We are underweight U.S. Treasuries. Overall, we see long-term yields moving higher as investors demand greater term premium – the extra return that investors demand to compensate them for the risk of holding long-term bonds amid persistent inflation and high debt loads. That's partly why we favor inflation-linked bonds - we expect inflation to persist and this isn't reflected in current pricing. We've also started to prefer short-term over long-term government bonds. We're neutral European government bonds, but we think the market pricing of the ECB is unrealistically hawkish given the deteriorating growth outlook on the back of the energy crisis.

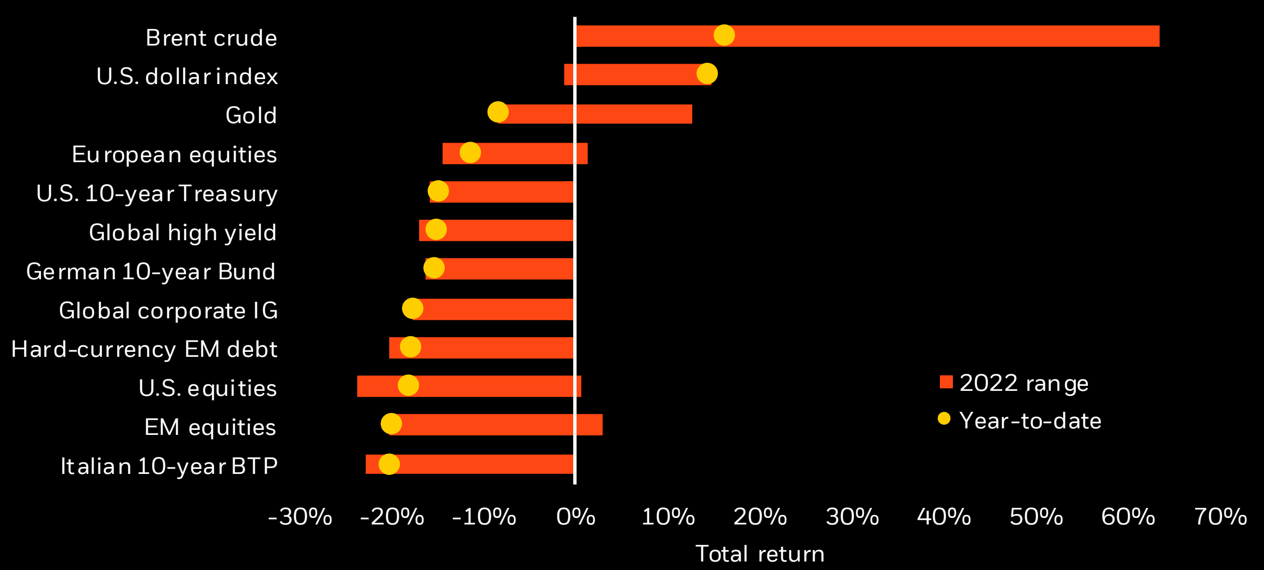
Our bottom line: The new regime of macro volatility is taking root with weaker growth, persistent inflation and volatile markets. Our whole portfolio approach prompts us to stick with our tactical views especially with the macro deterioration since our last update. We like credit over equities on valuations. High quality credit can also weather a recession better than stocks, we think. Persistent inflation keeps us away from longer-term nominal government bonds and makes inflation-linked bonds more attractive. Shorter-term government bonds are looking better because market pricing of policy rates looks too hawkish to us and recession risks are underappreciated. We think economic damage from rate hikes, and the energy crunch in Europe, will eventually lead central banks to stop hiking, but not anytime soon given persistently high core inflation.

Market backdrop

U.S. equities slumped and Treasury yields pushed near this year's highs after data showing a renewed rise in U.S. core inflation in August, suggesting core higher inflation will persist. That prompted the market to price in a third-straight 0.75% rate hike by the Fed next week and more big hikes for the rest of this year. We see the Fed hiking rates through year-end. Yet we doubt the Fed will acknowledge the recession needed to bring inflation back to its 2% target in its projections next week.

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. 16, 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

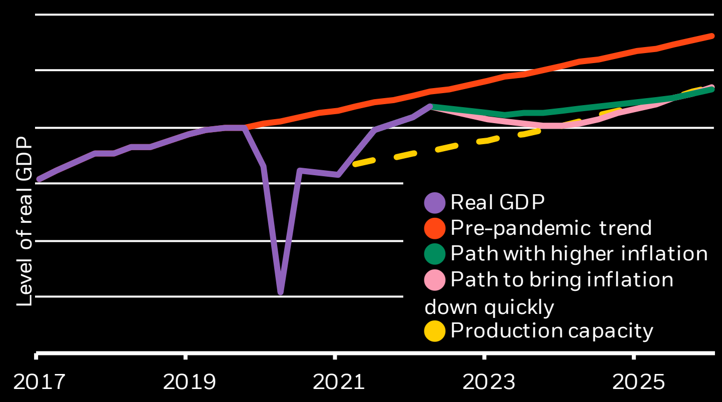
Central banks appear set on doing whatever it takes to get inflation back down to 2% as quickly as possible and avoid any risk of inflation expectations de-anchoring. Yet – as Jean and Alex explain in our latest Macro Take – they are mostly silent about the cost of that for growth. We think it would require a deep and painful recession (see the pink line on the chart). But there's an alternative.

Central banks could reduce the hit to growth by taking longer to bring inflation back to target (green line). That would give the economy a chance to rebalance as production capacity slowly recovers (yellow dotted line). The cost of that choice is inflation staying somewhat higher for longer. But if inflation expectations remain anchored as they are now, that could overall be a better outcome for society.

This is not an easy economic environment to navigate. The question is - which is the least bad outcome? It's time for a public debate. Read the full blog and head over to Twitter to cast your vote on what's the right balance between growth and inflation.

An alternative path for growth

Illustrative GDP scenarios, 2017-2025



Forward-looking estimates may not come to pass. Source: BlackRock Investment Institute, Sept. 2022. Notes: The chart shows a stylized path for demand in a hypothetical economy, measured by real GDP (in purple), and a projection of pre-Covid trend activity (in orange). The yellow line shows how much production capacity may have fallen since Covid. The pink line shows a hypothetical projection of GDP consistent with bringing inflation down to 2% by the end of 2024, while the green line shows an alternative path in which inflation remains above 2% over the same period.

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. 21	Fed policy decision	**Sept. 23**	Global flash PMIs
Sept. 22	Bank of England and Bank of Japan policy decisions		

The Fed seems determined to get inflation down to 2% without recognizing the extent of the contraction needed to do so, in our view. The upside surprise in the August U.S. CPI confirms why we expect the Fed to hike rates by 0.75% for a third straight time. The BoE has recognized the inflation-growth trade-off it faces and still seems determined to trigger a recession to fight inflation – especially after the UK fiscal response to the energy shock.

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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