Weekly commentary

January 17, 2023

BlackRock

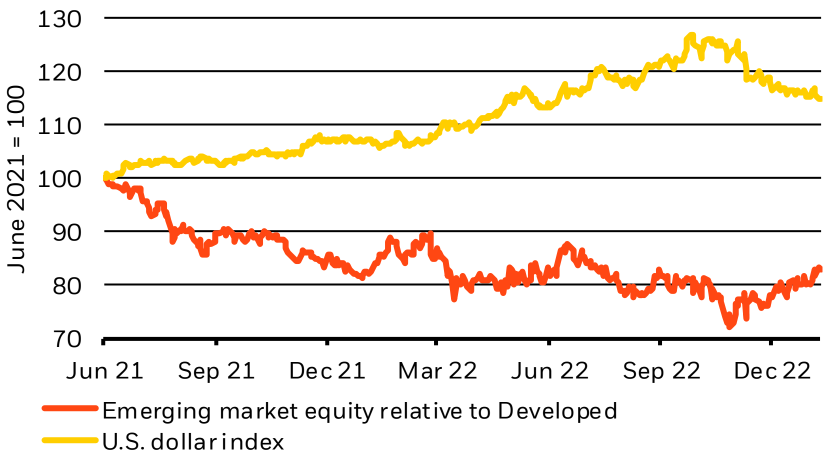
Brighter backdrop for emerging assets

- Emerging markets have weathered tightening financial conditions. We now see a relatively good backdrop for EM assets as EM rates peak and China reopens.
- Stocks added to gains and bond yields fell as markets priced in Federal Reserve rate cuts later in 2023. We don't think inflation will cool enough to allow for cuts.
- China GDP data due this week are unlikely to capture the rapid reopening that's underway. The Bank of Japan could surprise with policy changes.

Emerging markets (EM) have weathered rapid rate hikes in developed markets (DM). Central banks were ahead of DM peers in tightening, and high commodity prices helped EM producers. We see the backdrop for EM assets turning more positive as EM rates peak, DM central banks pause, the U.S. dollar weakens and China reopens. By contrast, the damage of higher rates has yet to fully materialize in DM. We prefer selected EM equities and bonds over DM peers as a result.

Relative retreat

Emerging equity relative performance and the U.S. dollar, 2021-2023



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2023. Note: The chart shows MSCI Emerging Markets Index total return index divided by MSCI World (orange) and the U.S. dollar DXY index (yellow) rebased to 100 at the start of June 2021.

EM economies proved resilient to what should have been a big hit from tightening global financial conditions as the Fed embarked on the fastest hiking cycle since the 1980s. We see several reasons why. EM external balances have improved, central banks were ahead of DM in policy tightening, and higher commodity prices limited the fallout. Yet EM equities have underperformed DM peers – down nearly 20% since mid-2021 (orange line), when many EM central banks began to tighten policy. This slump might be warranted if there were some systemic risk for EM looming – but we don't see that now. We think the long EM stock slide and recent rally show a lot of economic damage is now in the price as the EM backdrop turns more supportive. The U.S. dollar's retreat (yellow line) and China's reopening rally also helped EM assets in recent months.

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We think the backdrop will turn more positive for EM, building on recent resilience. EM generally has higher levels of currency reserves, smaller current account deficits, improved external balances and better debt maturity mixes than they did in past DM tightening cycles that sparked volatility. The weaker links among EM are small and not a broader threat, in our view. We think this all helped EM avoid a "taper tantrum"-type investor flight when global financial conditions tightened. In fact, investors favored EM: our data shows inflows into EM equity exchange-traded funds hit a record in 2022.

We also see slowing tightening cycles in EM. Some EM central banks were as much as a year ahead of DM in hiking rates to combat inflation. We expect some divergence - inflation expectations in Brazil are declining, but the energy crunch in Europe is likely to keep inflation pressures higher in the EM countries of the continent. We see DM central banks pausing as the economic damage of their tightening becomes clearer – and as inflation cools from highs but still stays above pre-Covid levels. A pause in the Fed's rate hikes would likely help spur a further retreat in the U.S. dollar. The risk? Markets have been pricing in Fed rate *cuts* later this year – something we don't expect to happen given persistent inflation.

China's reopening also brightens the view on EM as domestic demand restarts. Chinese assets represent a sizable share of EM indexes, so we see overall EM as a beneficiary of the reopening. Rising Chinese demand is likely to benefit other EM exporters with strong ties to China as growth rebounds, too. We estimate China's economic growth will be above 6% in 2023, but it will be tempered by falling exports as goods demand cools with spending shifts in developed economies away from goods and toward services. That makes consumer spending and business investment even more critical in gauging how strong China's recovery can be. We prefer Chinese assets to DM peers as well. Structural risks including an aging population and geopolitical tensions with the U.S. persist, but a strong rally in risk assets since October is becoming harder for some tactical investors to ignore.

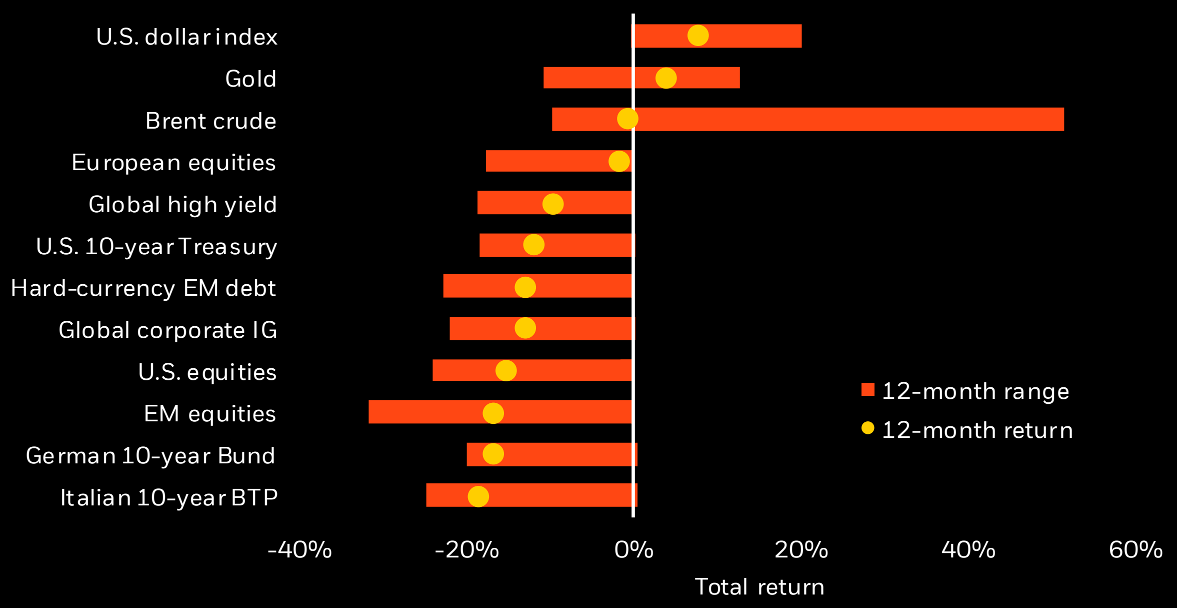
Our bottom line: We see a more positive EM backdrop as DM central banks pause, the dollar weakens and China reopens. We take a selective approach across EM – with a wide range of factors at play, from external balances to idiosyncratic sovereign risk. We prefer EM over DM stocks – we think more damage is in the price from earlier hiking cycles. We're neutral EM debt due to higher commodity prices and prefer it over long-term DM government bonds. Long-term DM yields don't reflect the term premium, or compensation for risk, we think investors will demand in this regime of higher macro volatility.

Market backdrop

Global stocks added to gains this month, with European shares leading the way. U.S. Treasury yields retreated further, while the U.S. dollar index hit seven-month lows. The market is still pricing in Fed rate cuts later this year as inflation cools, as reflected in last week's CPI. We think inflation will come down a lot this year – but not enough for the Fed to cut rates. We see the Fed pausing rate hikes once the damage from its policy overtightening is clear and then staying on hold.

Assets in review

Selected asset performance, 12-month 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 Jan. 12, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current 12-month 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.

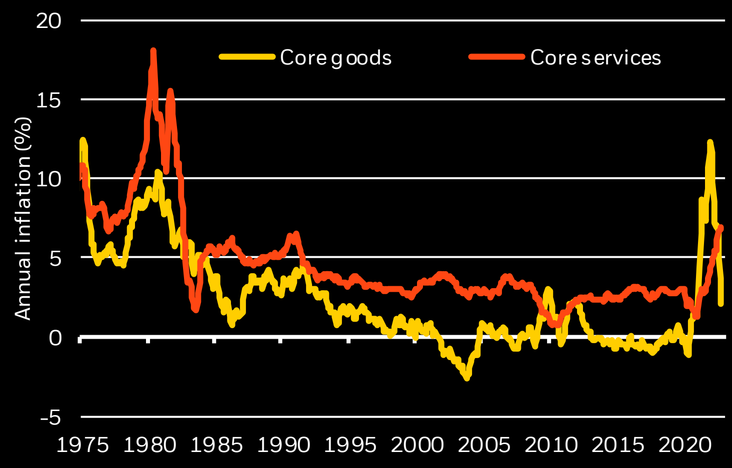
Macro take

U.S. headline and core inflation are set to fall a lot this year as some of the supply constraints that have been driving it up start to ease. One big shift: consumers' pandemic splurge on goods is over and services are back in vogue. That's bringing goods prices down rapidly. Last week's data showed another drop in core goods inflation. See the chart.

There's more room for goods prices to fall, especially relative to core services. But there's a limit to how far inflation will come down, we think. Core services inflation remains high because a major supply constraint – a worker shortage – is not easing and is unlikely to anytime soon. That's why we think inflation is likely to settle closer to 3% than 2%. Like the Federal Reserve, we'll be watching pay growth and core services closely as that's what will determine where inflation ultimately settles. But it will take months for the picture to become clear and the Fed will need more evidence to be convinced inflation is falling enough. That's why we don't think it will deliver the interest rate cuts later this year that the market is expecting. See all our blog posts here.

Inflation heads lower – but how far?

U.S. core goods and services CPI inflation, 1975-2022



Sources: BlackRock Investment Institute, with data from the U.S. Bureau of Labor Statistics, January 2023. Notes: The chart shows the annual change in U.S. core goods and services consumer price indexes.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- That damage is building. In the U.S., it's most evident in rate-sensitive sectors. Surging mortgage rates have cratered sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- In Europe, the hit to incomes from the energy shock is amplified by tightening financial conditions.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think they will halt rate hikes once the economic damage becomes clear.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- The case for investment-grade credit has brightened, in our view. We think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower yields. Agency mortgage-backed securities can also play a diversified income role. Short-term government debt also looks attractive at current yields.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer investment-grade credit over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The cycle of outsized rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. As the damage becomes clear, the "politics of recession" will take over.
- Even with a recession coming, we think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

Jan. 17	China GDP, retail sales, unemployment; UK jobs data	**Jan. 19**	U.S. housing starts; Japan CPI
Jan. 18	UK CPI; Bank of Japan policy decision	**Jan. 20**	U.S. existing home sales

China GDP is likely to slow, reflecting the disruptions from the rapid spread of Covid-19, but we see the reopening spurring a strong rebound this year. The Bank of Japan meets and may further widen its yield curve control for 10-year yields – or abandon it altogether. Japan's CPI data for December may provide the impetus for any such move.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, January 2023

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. 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.
Credit	+2	+1	Strategically, we are significantly overweight global investment grade on attractive valuations and income potential given higher yields. We turn neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're also overweight investment grade and neutral high yield. We prefer to be up in quality. We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
Govt bonds	-1	-1	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.
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, January 2023

Underweight | **Neutral** | **Overweight** | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare.
United States	-1	We are underweight. The Fed is set to raise rates into restrictive territory. Earnings downgrades are starting but don't yet reflect the coming recession.
Europe	-1	We are underweight. The energy price shock and policy tightening raise stagflation risks.
UK	-1	We are underweight. We find valuations expensive after their strong relative performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral. Activity is restarting, but we see China on a path to lower growth. Tighter state control of the economy makes Chinese assets riskier, in our view.
Emerging markets	Neutral	We are neutral. Slowing global growth will weigh on EMs. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Short U.S. Treasuries	Neutral	We are neutral. We remain invested in the front end due to attractive income potential.
Global inflation-linked bonds	+1	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
European government bonds	-1	We are underweight the long end. We expect term premium to raise long-term yields and high inflation to persist. Rate hikes are a risk to peripheral spreads.
UK gilts	-1	We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.
China government bonds	Neutral	We are neutral. Policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global IG credit	+2	We are significantly overweight. High quality corporates' strong balance sheets imply IG credit could weather a recession better than stocks.
U.S. agency MBS	+1	We are overweight. We see the asset class as a high-quality exposure within a diversified bond allocation. Soaring U.S. mortgage rates boost potential income.
Global high yield	Neutral	We are neutral. We prefer up-in-quality credit exposures amid a worsening macro backdrop.
Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices yet it is vulnerable to rising U.S. yields.
Emerging local currency	Neutral	We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
Asia fixed income	Neutral	We are neutral 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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