Weekly commentary

January 23, 2023

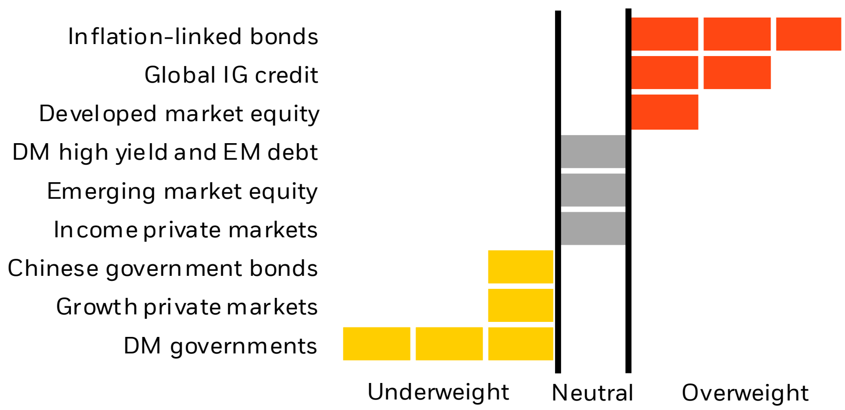
Market view too rosy – for now

- China's reopening, lower energy prices and cooling inflation reinforce our long-term positive view on equities. Yet we think market optimism has come too soon.
- Stocks paused their rally and bond yields steadied after recession worries returned. We think we are starting to see damage from policy overtightening.
- We're watching global flash PMIs this week for signs of recession and look to the U.S. PCE report to see how services spending is affecting core inflation.

Markets have leapt ahead this year, driven by China's reopening, falling energy prices and slowing inflation. This has spurred hopes of a soft economic landing, plummeting inflation and interest rate cuts. We see markets vulnerable to negative surprises – and unprepared for recession. This is why we underweight developed market (DM) stocks in the near term. Yet the developments reinforce our long-term views and the importance of an investor's time horizon.

Horizon matters

Our strategic (long-term) asset views, January 2023



Source: BlackRock Investment Institute, January 2023. Data as of Sept. 30, 2022. Notes: The chart shows our asset views on a 10-year view from an unconstrained U.S. dollar perspective against a long-term equilibrium allocation. This material represents an assessment of the market environment at a specific time and is not intended as a recommendation to invest in any particular asset class or strategy, a forecast of future events nor a guarantee of future results.

An investor's time horizon is key when gauging how 2023 developments so far affect investments. These events have upped our confidence in our strategic views on a horizon of five years and more. Economic risks like a closed China and ultra-high inflation have lessened, further underpinning our strategic overweight of stocks, as the chart shows. Equity valuations look reasonable versus our long-term expectations. The stock rally hints at how markets will likely react once inflation eases and rate hikes pause, buoying prospects for long-term corporate earnings. Yet before this outlook becomes reality, we see DM stocks falling when recessions we expect manifest. We think the U.S. economy's 2023 calendar year growth will then be positive. Investors with a longer-term investment horizon can position for the rebound now but could see more pain to come in the near term.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We may turn more positive on stocks when the damage we see ahead is priced or our assessment of market risk sentiment shifts. For now, the fading risks after this year's positive developments are key to our strategic views. Case in point: inflation. We have always expected it to fall as pandemic drivers – like consumer spending's shift from services to goods – reversed. What's key is our view of U.S. inflation landing closer to 3% than the Federal Reserve's 2% target. Markets aren't pricing that in. Plus, longer-term trends like aging demographics, geopolitical fragmentation and the energy transition mean inflationary pressures will be higher than in the past. Treasury yields are falling further away from where we think they'll climb to in the long term as investors demand more term premium, or compensation for the risk of holding them amid persistent inflation and heavy debt loads. We don't think nominal sovereign bonds can diversify portfolios anymore, and our preference for inflation-linked bonds is stronger given 2023 events. We see stock returns offering more compensation for risk than bonds.

Yet investors with shorter investment horizons should be wary, in our view. Falling inflation has raised market hopes for rate cuts this year but that optimism may be built on shaky ground. We don't see rate cuts even once recessions hit. The reason: Central banks are deliberately causing them to try to push inflation down to a tolerable level, we believe. We see them keeping rates higher for longer as a result. We think recessions are more likely in developed economies given the lagged effect of rate hikes. China's reopening could support global growth. We see China's economic growth above 6% in 2023 despite its shrinking trade activity. But this cushioning of global growth would temper DM central banks' efforts to crush economic activity to try to get inflation down to target, in our view. DM recessions should be the key focus tactically. Yet markets don't appear to price in that outcome. We think that makes them vulnerable to more negative surprises – and volatility – in 2023.

Our bottom line: Time horizons matter – a lot. We're strategically overweight DM stocks because we think downside risks have lessened, boosting potential long-term returns. Yet we see near-term risks tilted against DM stocks, with earnings growth forecasts not fully reflecting the recessions ahead. So we're underweight tactically and prefer emerging market equities. We like public equities over private growth assets and expect entry points to grow more attractive. We're underweight long-term government bonds tactically and strategically as we expect fewer diversification benefits and a rise in yields. Our expectation for persistent inflation is why we like inflation-linked bonds on both horizons. We like high-quality credit for income in both short- and long-term allocations. Look out for a quarterly update to our strategic views soon.

Market backdrop

Global stocks paused from their rally this year and government bond yields steadied from their drop. Surprisingly weak U.S. retail sales and industrial production revived concerns about recession. Still, Federal Reserve and European Central Bank officials made the case for further rate hikes. We think investors betting on Fed rate cuts later in the year are likely to be disappointed – even as a recession is foretold and we start to see more economic damage from their policy overtightening.

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. 19, 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

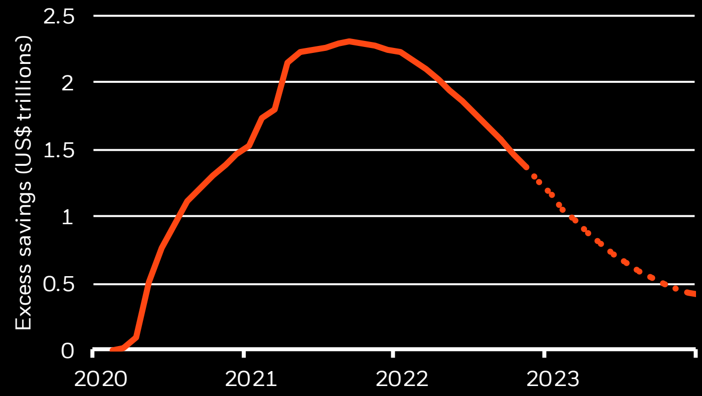
We expect a mild recession in the U.S. later this year as continuing rate hikes and the lagged effects of past hikes collide with consumers depleting their pandemic savings.

Many people built up extra savings in the pandemic when they stopped spending on things like restaurants and travel, and also received extra income from the government in the form of stimulus checks. See the chart. As a result, U.S. consumers are currently spending more of their incomes than usual, saving just 2.4% of their total disposable income compared with a pre-pandemic average of 7.6%.

But those savings are running out – and if they keep being used up at the same rate, we estimate they will be close to depletion by the second half of this year. If normal savings behavior then returns and the savings rate moves up closer to its pre-pandemic average, as we expect, consumer spending could start to contract by the end of the year. We think that blow to GDP, plus rate hikes, will be enough to push the U.S. into recession. Read more in our latest macro perspectives: Reversals, but recession without rescue.

U.S. households run down savings

Actual and projected U.S. accumulated excess savings, 2020-24



Forward-looking projections may not come to pass. Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, January 2023. Notes: The chart shows our estimate of U.S. households' accumulated excess savings since 2020. Excess savings are defined as monthly savings over and above average savings over 2018-2019. An increase in the accumulated savings stock implies households saved more than average in a month, and a decrease means they saved less than average. The dotted line denotes our forecast of the accumulated saving stock, based on our projection of household spending.

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. 24	Global flash PMIs	**Jan. 26**	U.S. Q4 GDP
Jan. 25	Germany Ifo survey	**Jan. 27**	U.S. PCE inflation and consumer spending

We're looking at flash PMIs for signs of recession in the U.S. and Europe. We will also be watching the U.S. PCE report for more signs of the spending shift back to services from goods and how that is affecting the Fed's favored gauge of core inflation, as well as the overall strength of household spending.

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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