Weekly commentary

January 30, 2023

BlackRock.

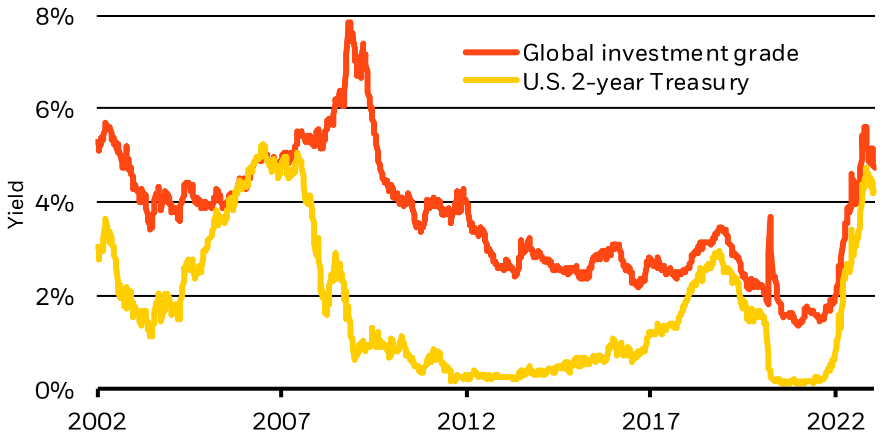
Higher rates reinforce income's appeal

- We don't see major central bank rate cuts this year, so we prefer to earn income in short-term bonds, high-grade credit and agency mortgage-backed securities.
- U.S. stocks rose and Treasury yields were mostly steady. U.S. Q4 GDP was resilient but declining consumer spending suggests growth is slowing quickly.
- The Fed and the European Central Bank anchor policy decisions this week. We see them hiking and holding rates higher for longer than markets expect.

Major central banks are set to hike policy rates again this week and keep them higher, counter to market views for cuts this year. We see this disconnect resolving and favoring higher rates. That's because we think inflation will fall fast but stay above target. Rates staying high plus the political tussle over raising the U.S. borrowing limit are market risks. We prefer to earn income and like short-term government bonds, high-grade credit and mortgage-backed securities.

Yield is back

Investment grade and short-term government debt yields, 2002-2022



Source: BlackRock Investment Institute, with data from Refinitiv, January 2023. Notes: The chart shows yields for the Bloomberg Global Aggregate Corporate Index and benchmark two-year U.S. Treasuries.

Income is finally back in fixed income thanks to higher yields and coupons. Short-term government bonds and investment grade (IG) credit now offer some of the highest yields in the last two decades. See the chart. We prefer to earn income right now from these high-quality fixed income assets as rates rise and stay high. Fixed income's appeal remains intact the longer central banks keep rates near their peak. The lack of duration – or the sensitivity of bond prices to interest rates – in short-term paper also helps preserve income even if yields rise anew. Global IG credit offers high-grade, liquid income – and we think the strong balance sheets of high-quality companies that refinanced debt at lower rates can weather the mild recession we see ahead. We also like agency mortgage-backed securities (MBS) to diversify income.

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BlackRock **Investment** Institute

We see major central banks on a path to overtighten policy because they're worried about the persistence of underlying core inflation, excluding food and energy prices. PCE data in the U.S. confirmed the outlook for core inflation hasn't improved, and it's tracking to be well above policy targets into 2024. Core services inflation is proving sticky even as goods prices fall. That stickiness is tied to wage pressures in the labor market that we see remaining tight. We think central banks will want more evidence that core inflation and wage pressures are sustainably subsiding before they declare victory on inflation and think about easing policy. This will take a long time – and is unlikely to happen this year, in our view. This week, the Fed and ECB are set to push rates further up again. We see the Fed hiking 0.25% and the ECB raising 0.5%, with more hikes likely to follow. Then we see them keeping rates high. But markets are pricing rate cuts in 2023 even as both central banks insist they will stay the course. That disconnect needs to be resolved, and we think it will be in favor of higher rates as inflation persists above central banks' 2% target. Rates staying high is one reason we prefer earning income with shorter duration paper.

Another reason is term premium – the compensation investors demand for holding long-term government bonds. We see investors seeking more term premium with higher inflation and other near-term risks on the horizon. Political pressure on the Bank of Japan to change its yield curve control policy is likely to ramp up with inflation running at a four-decade high. The risk: a global spillover from higher Japanese government bond yields to global yields. We think moving away from yield curve control would be like a move away from a currency peg – even tweaks could lead to abrupt market dislocations. Risks over raising the U.S. borrowing cap are also in focus now after the U.S. hit its debt ceiling this month – this reinforces our view that investors will once again demand term premium. Negotiations are likely to go down to the wire this summer and could be as fraught as 2011, when S&P Global downgraded the U.S. triple-A credit rating. We ultimately expect a resolution. If a U.S. default were to occur, it would likely be technical in nature, meaning the U.S. would prioritize debt payments over other obligations. We would expect only a temporary rise in selected Treasury bill yields as the default date nears. Another debt ceiling impasse could also pressure risk assets as in past episodes – this keeps us cautious on U.S. equities.

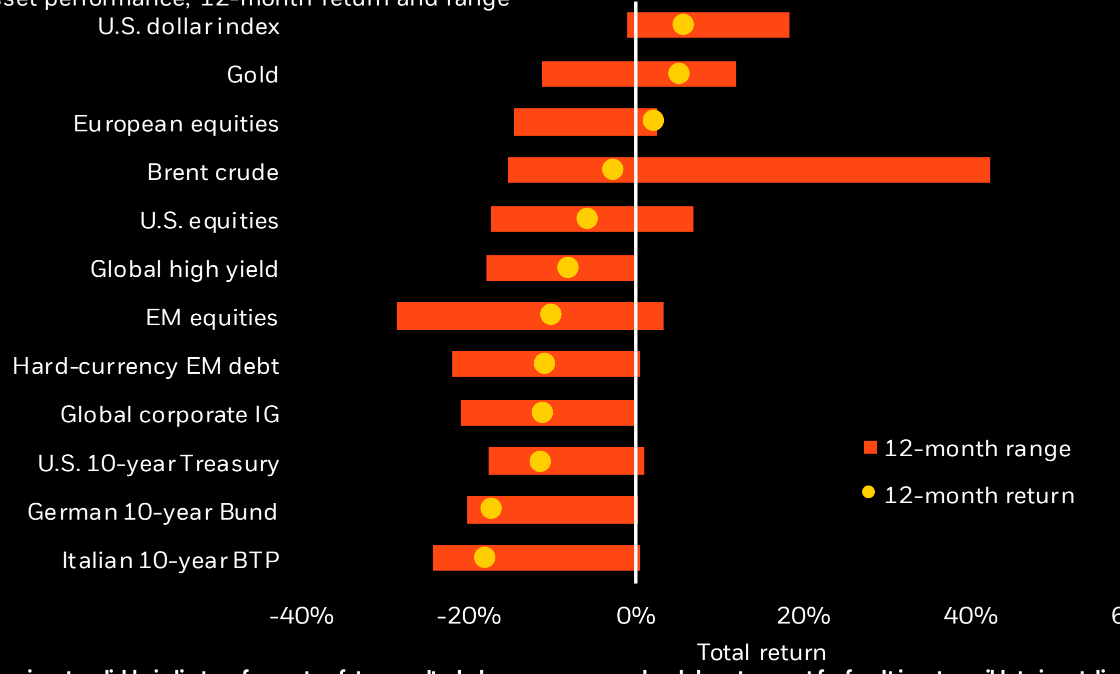
Our bottom line: Rates staying high and the political tussle over the U.S. debt ceiling are market risks. We take a granular view on fixed income at this juncture. We tactically like short-term government bonds, high-grade credit and agency mortgage-backed securities for attractive income.

Market backdrop

U.S. stocks climbed and bond yields were mostly steady, with European and emerging market shares outperforming the U.S. on investor inflows. U.S. GDP was resilient in the last quarter of 2022. Consumer spending helped prop up growth, but we see signs of weakness beneath the surface. The U.S. PCE data showed consumer spending was losing momentum at the end of the year and suggests that growth is slowing more quickly than we expected.

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. 26, 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 think inflation will fall a lot this year. One key reason: U.S. consumer spending patterns are normalizing again. People splurged on goods in the pandemic, causing goods prices to shoot up relative to other prices. Inflation surged as a result. But goods prices have now started falling rapidly as consumers revert to their pre-pandemic spending patterns – as further evidenced by last week's U.S. consumer spending data. See the chart.

We expect that trend to persist, meaning overall core inflation will come down sharply this year. But it could be a rollercoaster. The smoothness of the ride depends on how quickly spending patterns revert and goods prices fall. Where inflation settles once the adjustment is complete depends on what happens to wages and services inflation. That remains stubbornly high. Unless that changes, overall core inflation is not likely to settle back near the Federal Reserve's 2% target.

Read more in our latest macro perspectives: Reversals, but recession without rescue.

Inflation to fall as spending normalizes

U.S. goods share of real consumer spending, 2008-2022

Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, January 2023. Notes: The chart shows real U.S. personal consumer expenditure on goods as a share of total real U.S. personal consumer expenditure.

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. Higher mortgage rates have hurt 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. 31	Euro area flash Q4 GDP; U.S. consumer confidence	**Feb. 2**	European Central Bank, Bank of England policy decisions
Feb. 1	Fed policy decision; U.S. job openings; euro area inflation	**Feb. 3**	U.S. payrolls, U.S. ISM services PMI; China services PMI

The Fed and the European Central Bank anchor this week's central bank decisions. We see them both pushing up rates further and pushing back against market expectations for rate cuts. The U.S. services PMI and payrolls data will give the latest view on recession risks. We think further resilience in activity and the labor market could embolden the Fed.

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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