

# Weekly commentary

January 30, 2023

**BlackRock**

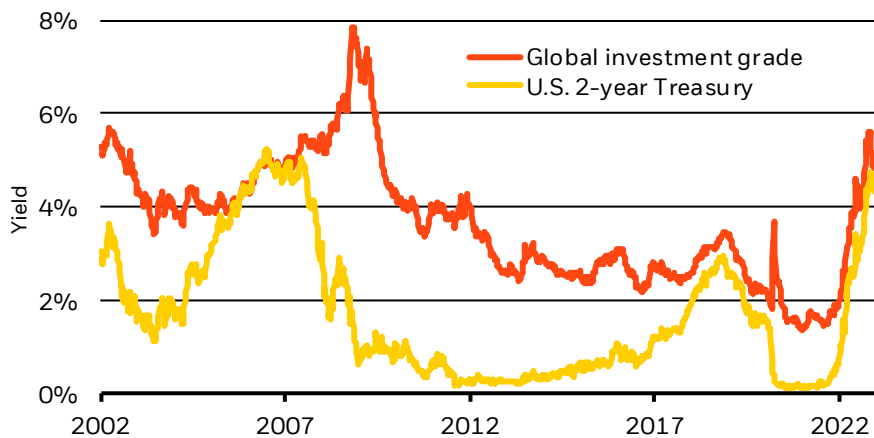
## Higher rates reinforce income's appeal

- 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.



**Wei Li**

Global Chief Investment Strategist – BlackRock Investment Institute



**Alex Brazier**

Deputy Head – BlackRock Investment Institute



**Kurt Reiman**

Senior Strategist for North America – BlackRock Investment Institute



**Nicholas Fawcett**

Macro research – BlackRock Investment Institute

Visit [BlackRock Investment Institute](#) for insights on the global economy, markets and geopolitics.

**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.

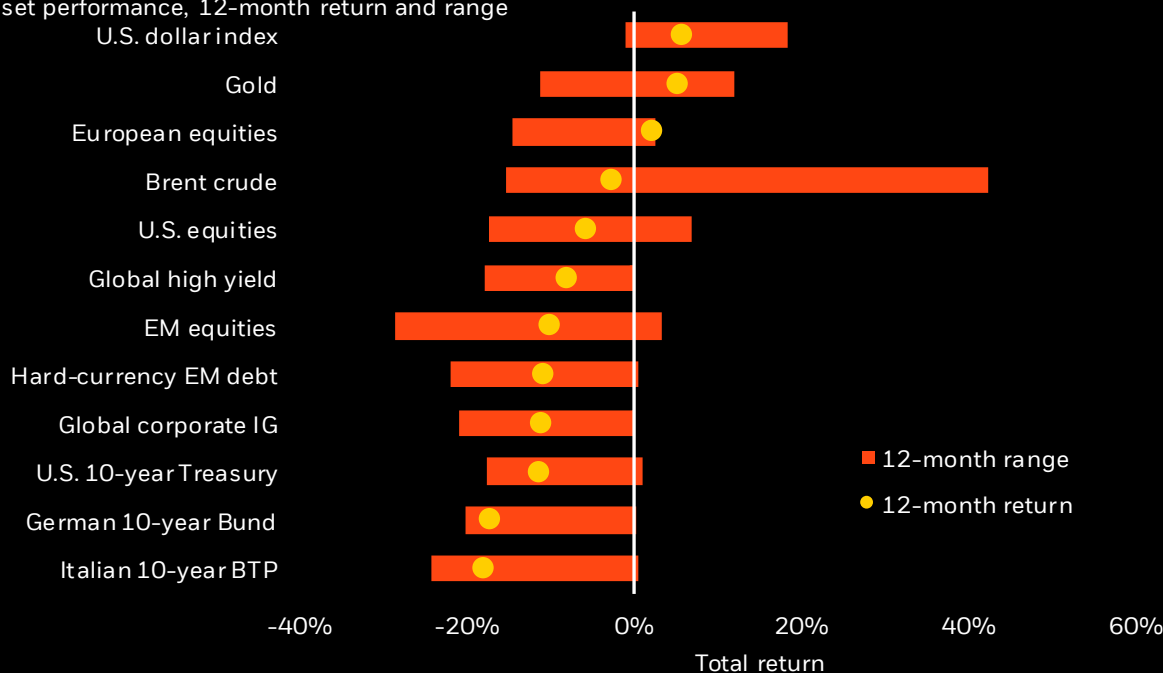
Our bottom line: Rates staying high and the political tussle over the U.S. debt ceiling are market risks. We take a granular view on fixed income at this juncture. We tactically like short-term government bonds, high-grade credit and agency mortgage-backed securities for attractive income.

## 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	<p style="text-align: center;">+1</p>	<p style="text-align: center;">-1</p> <p>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.</p>			
Credit	<p style="text-align: center;">+2</p>	<p style="text-align: center;">+1</p> <p>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.</p>			
Govt bonds	<p style="text-align: center;">-1</p>	<p style="text-align: center;">-1</p> <p>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.</p>			
Private markets	<p style="text-align: center;">-1</p>	<p style="text-align: center;">—</p> <p>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.</p>			

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
<b>Developed markets</b>	-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.
<b>China</b>	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.
<b>Emerging markets</b>	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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security. BIIM0123U/M-2707245-5/6

# BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

**General disclosure:** This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive and no representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. The opinions expressed are as of Jan. 30, 2023 and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.

In the **U.S. and Canada**, this material is intended for public distribution. **In the European Economic Area (EEA):** this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311. For your protection telephone calls are usually recorded. **In the UK and Non-European Economic Area (EEA) countries:** this is Issued by BlackRock Advisors (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL, Tel: +44 (0)20 7743 3000. Registered in England and Wales No. 00796793. For your protection, calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock. **In Italy,** For information on investor rights and how to raise complaints please go to <https://www.blackrock.com/corporate/compliance/investor-right> available in Italian. **For qualified investors in Switzerland:** This document is marketing material. This document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA"). For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: [www.blackrock.com/finsa](http://www.blackrock.com/finsa). **For investors in Israel:** BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. **In South Africa,** please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. **In the DIFC** this material can be distributed in and from the Dubai International Financial Centre (DIFC) by BlackRock Advisors (UK) Limited – Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it. BlackRock Advisors (UK) Limited - Dubai Branch is a DIFC Foreign Recognised Company registered with the DIFC Registrar of Companies (DIFC Registered Number 546), with its office at Unit 06/07, Level 1, AlFattan Currency House, DIFC, PO Box 506661, Dubai, UAE, and is regulated by the DFSA to engage in the regulated activities of 'Advising on Financial Products' and 'Arranging Deals in Investments' in or from the DIFC, both of which are limited to units in a collective investment fund (DFSA Reference Number F000738). **In the Kingdom of Saudi Arabia,** issued in the Kingdom of Saudi Arabia (KSA) by BlackRock Saudi Arabia (BSA), authorised and regulated by the Capital Market Authority (CMA), License No. 18-192-30. Registered under the laws of KSA. Registered office: 29th floor, Olaya Towers – Tower B, 3074 Prince Mohammed bin Abdulaziz St, Olaya District, Riyadh 12213 – 8022, KSA, Tel: +966 11 838 3600. The information contained within is intended strictly for Sophisticated Investors as defined in the CMA Implementing Regulations. Neither the CMA or any other authority or regulator located in KSA has approved this information. The information contained within, does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. Any distribution, by whatever means, of the information within and related material to persons other than those referred to above is strictly prohibited. **In the United Arab Emirates** is only intended for – natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. **In the State of Kuwait,** those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. **In the Sultanate of Oman,** to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. **In Qatar,** for distribution with pre-selected institutional investors or high net worth investors. **In the Kingdom of Bahrain,** to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. The information contained in this document, does not constitute and should not be construed as an offer of, invitation, inducement or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. **In Singapore,** this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. **In Hong Kong,** this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. **In South Korea,** this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations). **In Taiwan,** independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In Japan,** this is issued by BlackRock Japan, Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In Australia,** issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL). The material provides general information only and does not take into account your individual objectives, financial situation, needs or circumstances. **In China,** this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. **For Other APAC Countries,** this material is issued for Institutional Investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions). **In Latin America,** no securities regulator within Latin America has confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico thus is subject to strict rules. For more information on the Investment Advisory Services offered by BlackRock Mexico please refer to the Investment Services Guide available at [www.blackrock.com/mx](http://www.blackrock.com/mx)

©2023 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

**BlackRock**

Not FDIC Insured • May Lose Value • No Bank Guarantee