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Weekly commentary

BlackRock

April 10, 2023

High conviction: inflation-linked debt

- We upped our overweight of inflation-linked bonds in March to quickly take advantage of the market pricing lower inflation – our new playbook in action.
- Bond yields rose after data showed a still-tight U.S. labor market. We think that keeps inflation sticky and makes Federal Reserve rate cuts this year unlikely.
- U.S. inflation data this week will show core inflation remaining well above the Fed's 2% target. We don't see the Fed hiking enough to get it all the way to 2%.

Major central banks are hiking rates into recession to try to get inflation to policy targets. Inflation fell when past recessions hit. Pushing inflation to target now calls for a major recession. We expect a recession to help cool inflation but think the Fed will stop hiking before it gets severe. This week's data is likely to show U.S. inflation staying sticky. We think market pricing is underappreciating persistent inflation and took advantage of the dip in expected inflation in March to up our overweight.

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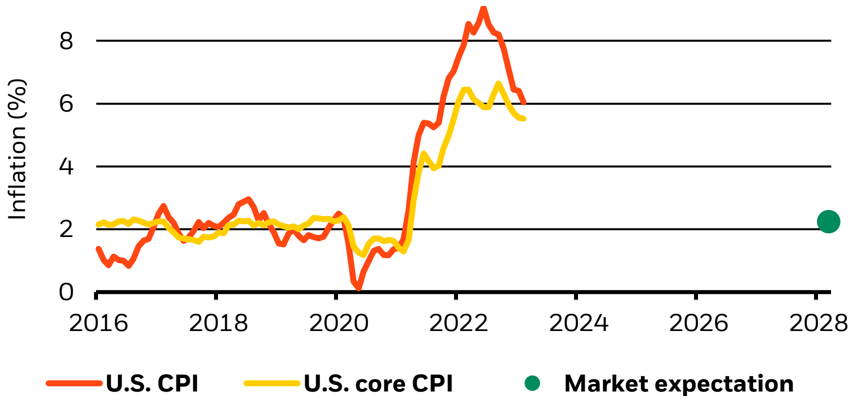
Sticking around

U.S. CPI inflation and market expectation, 2016-2028



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2023. Notes: The chart shows U.S. CPI and core CPI inflation and market pricing of what inflation will average over the five-year period that begins five years from today – also known as the 5-year/5-year inflation swap. Forward looking estimates may not come to pass.

Inflation-linked government bonds behaved more like risk assets in the past, underperforming nominal government bonds in economic downturns. Concerns about bank stability and recession spurred a return of this old behavior last month. That's the old playbook, in our view. U.S. core inflation is not on track to fall to the Fed's 2% target, like markets expect (see the green dot above). February Personal Consumption Expenditures (PCE) data confirmed this. We expect the Consumer Price Index (CPI) data out this week to do the same. Lower energy prices and falling goods inflation as consumer spending shifted back to services initially led a decline in core CPI inflation (yellow line). But some goods inflation is already ticking back up. A tight labor market that's boosting wage growth and services inflation is also making core inflation stubborn. Plus, supply shocks – like the surprise OPEC+ oil production cut – may cause brief spikes in headline inflation (dark orange line).

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The Fed is sticking to hiking rates to get inflation down to target, even as financial cracks start to appear. We think the Fed will eventually stop hiking when the damage becomes more apparent. That means it won't have done enough to create the deep recession needed to achieve its inflation goal, so it will be living with some above-target inflation. Updated Fed forecasts last month noted as much, with PCE inflation floating around 3% at year-end – even as the Fed expects growth to stall.

The breakeven inflation rate – or the market's pricing of future inflation – narrowed in March as markets saw inflation falling to 2% given the bank turmoil and nearing recession. We were already tactically overweight inflation-linked bonds. We used the repricing to go more overweight. Any old-playbook-style underperformance of inflation-linked versus nominal bonds presents opportunities, in our view. We think the market pricing in repeated rate cuts suggests investors are underestimating inflation's persistence and expecting central banks to come to the rescue. We see sticky inflation preventing cuts in 2023. The magnitude of our tactical overweight is now closer to our longstanding overweight from a strategic view of five years and beyond as structural trends like aging populations, geopolitical tension and the energy transition keep inflation higher.

We are neutral on euro area inflation-linked government bonds and prefer U.S. counterparts. The reason: European inflation is more likely to reach the European Central Bank's (ECB) 2% target. Not because inflation is less persistent – getting inflation to 2% will take a recession, just as in the U.S. But unlike the Fed, we see the ECB going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails. Consumers seem to agree, with their inflation expectations over three years ticking down closer to the ECB policy target, according to February ECB survey data. But at the moment, euro area inflation pricing is even higher than in the U.S. – and thus less attractive, in our view.

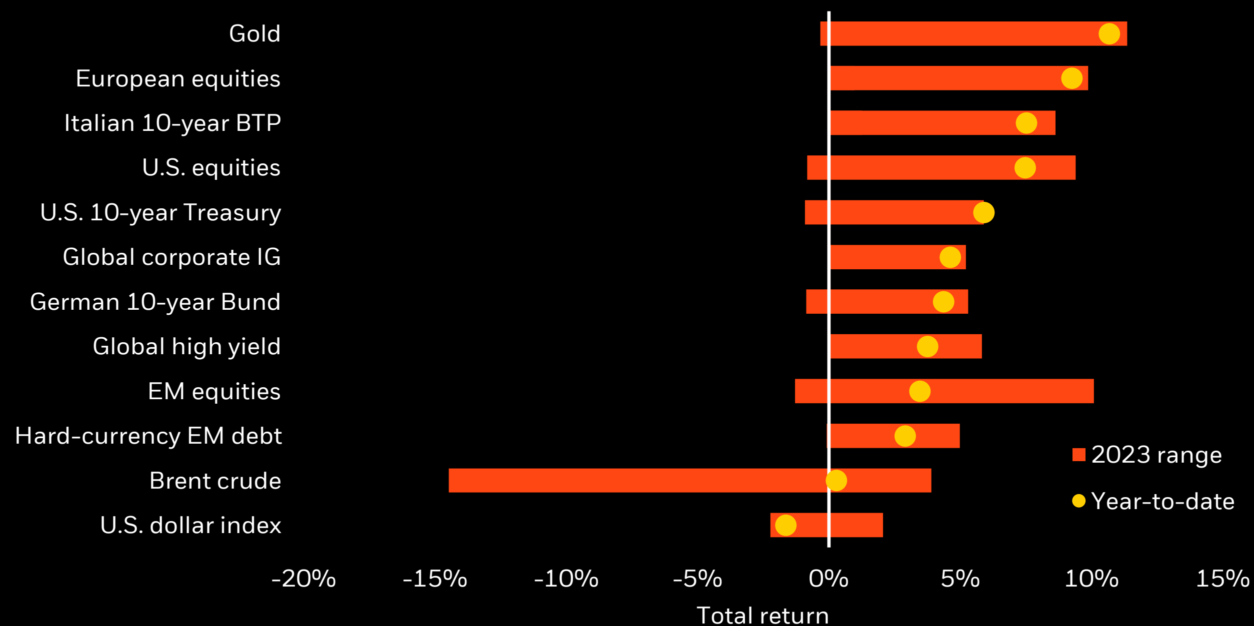
Bottom line: We think U.S. inflation will remain above the Fed's target for some time. We wield our new playbook and seized the opportunity to add to our existing tactical overweight to inflation-linked bonds in March – one of our highest conviction views. We see structural trends supporting higher inflation, so we've been overweight strategically for a few years. We like other assets that help portfolios with higher inflation. Infrastructure assets have the potential to hedge some of the effects of inflation, too. We remain tactically underweight developed market shares and expect corporate earnings to come under pressure – and the upcoming earnings season starting this week may reveal such damage. We prefer emerging market peers that better price in the economic damage we expect.

Market backdrop

U.S. and European equity indexes ended largely unchanged on the week heading into the Easter holiday. U.S. Treasury yields ticked back up after the U.S. jobs report showed another solid gain in payrolls, with the unemployment rate dropping back near a five-decade low. The market priced back in a potential Fed hike in May but is still eyeing multiple rate cuts later in the year. We don't see the Fed cutting policy rates later this year and prefer short-term government paper for income.

Assets in review

Selected asset performance, 2023 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 April 6, 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 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.

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Macro take

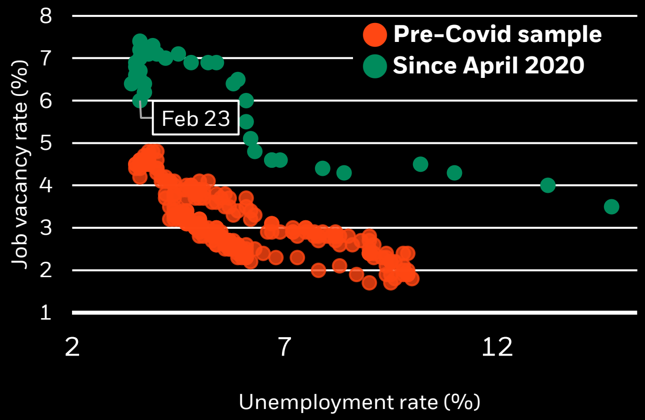
Last week's job vacancies data highlighted again that the U.S. economy is still beset with labor shortages. That's why the low unemployment rate hovering near a five-decade low is not a sign of strength but of a severe skills mismatch in the labor market.

The chart on the right, known as the Beveridge curve, demonstrates how efficient the labor market is at any given point in time in matching job seekers with available job openings. The green dots – representing the post-Covid period – show a structural shift relative to history, largely the result of a workforce skills gap that still persists.

The shortage of workers is keeping wage growth strong and core inflation elevated. We think policy rates are near their peak, yet we don't see the Fed coming to the rescue with rate cuts. They are instead engineering a slowdown that would push up the unemployment rate – and bring down wage growth. The Fed's own projections call for a 1 percentage point increase in the unemployment rate by the end of the year. Explore our recent Macro take blog posts here.

Labor market mismatches

U.S. vacancy rate and unemployment rate



Source: BlackRock Investment Institute, with data from Haver Analytics, April 2023. Notes: The chart shows the relationship between unemployment and job vacancies in the U.S. economy. – also known as the Beveridge curve.

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.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of 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, tighter financial conditions are biting even as the energy shock eases.
- 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.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- 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 very short-term government paper 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 rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. 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

April 10–17	China total social financing	**April 12**	U.S. CPI
April 11	China CPI	**April 14**	U.S. retail sales; U.S. consumer sentiment survey

The focus is on the U.S. CPI this week. It is likely to show that inflation is proving sticky and not on track to quickly fall to the Fed's 2% target. We think the market is underappreciating how persistent core inflation is proving. U.S. retail sales and consumer sentiment could offer signs of how much the Fed's rate hikes are cooling economic activity.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, April 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' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	+1	Neutral	Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.
Govt bonds	Neutral	-1	We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.
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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 2023

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

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
Equities	United States	-1	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
Equities	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
Equities	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
Equities	Japan	-1	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
Equities	**Emerging markets**	+1	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Equities	China	+1	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
Equities	Asia ex-Japan	Neutral	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Fixed Income	Short U.S. Treasuries	+2	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
Fixed Income	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
Fixed Income	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
Fixed Income	UK gilts	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. We prefer short-dated gilts for income.
Fixed Income	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
Fixed Income	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
Fixed Income	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
Fixed Income	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
Fixed Income	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
Fixed Income	Emerging local currency	+1	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
Fixed Income	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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