Weekly commentary

BlackRock

November 15, 2021

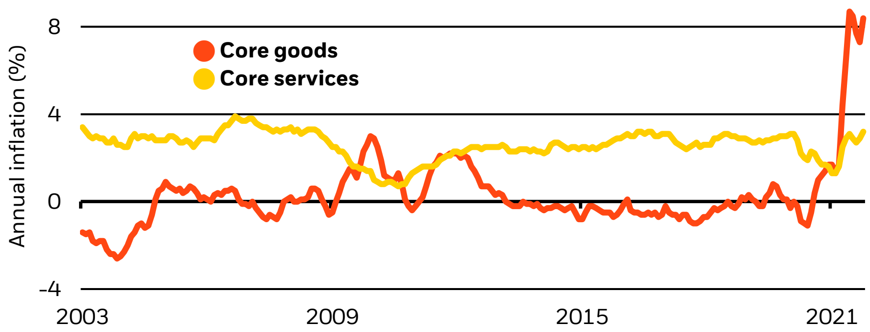
Inflation at heart of our Outlook Forum

- We see price pressures to persist in 2022, mostly driven by the unusual restart dynamics. Eventually, we see a higher inflation regime than pre-Covid.
- U.S. consumer price index (CPI) jumped more than expected in October, bringing annual inflation rate to 6.2%, the highest level in three decades.
- Data from China this week is expected to show a further slowdown in economic activity. UK CPI will also be in focus.

Inflation was at the heart of debates among BlackRock portfolio managers at our 2022 Outlook Forum last week. Inflation is being driven by the unusual supply shocks tied to the restart. We expect these imbalances to resolve over the next year, but see inflation as persistent and settling at a higher level than pre-Covid. We prefer equities in such an environment, as we expect a more muted yield response to inflation than in the past. This should keep real yields low, supporting stocks.

Unusual restart, unusual inflation

U.S. core CPI breakdown, 2003-2021



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Haver Analytics, November 2021. Notes: The chart shows the annual rate of the core goods and core services consumer price index (CPI).

The U.S. CPI rose more than expected in October. This caught markets off guard, but as we have argued previously we shouldn't be surprised by surprising data given the unique nature of the economic restart. It shows how little is known about restart dynamics. Although price rises are broad based, the mix of inflation shows the unusual restart dynamics at play. The run-up of inflation has been due to supply bottlenecks coupled with unusually strong household spending on goods rather than services. The shares of goods spending in the total personal consumption expenditures jumped to around 36%, the highest level in 15 years. Prices of goods excluding food and energy – which had been in deflation for most of the past decade – have surged way beyond core services prices, reflecting the restart disruptions and shifts in spending patterns. See the chart above. Participants at our 2022 Outlook Forum generally agreed: 1) that higher inflation will persist next year while spending on goods remains high and supply bottlenecks continue, and; 2) this supply-demand mismatch should resolve as the restart plays through, supply comes back on stream fully and spending on goods switches back to services. As a result we are still broadly pro-risk headed into 2022.

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BlackRock **Investment** Institute

Our *new nominal* theme has guided us all year. Central banks, especially those with new policy frameworks such as the Federal Reserve and European Central bank, are more tolerant of higher inflation. The Fed may have achieved its new inflation mandate to make up for past misses, but will likely still keep rates low to achieve its more ambitious full employment mandate. We have moved forward our expectation for the Fed to start raising rates next year – if not as soon as the market pricing. But what matters is the overall policy rate trajectory, not just the liftoff timing. We expect the most muted response of policy – and nominal government bond yields – to higher inflation in decades, underpinning the *new nominal*.

The policy reaction is not uniform. Other developed market central banks, such as the Bank of England, have signaled a policy rate path with steeper initial increases. That has created volatility in short-term interest rate markets over the past month. Thinning liquidity and crowded positions in bond markets have led to exaggerated moves and confusing yield signals. Yet even these central banks seem to be looking only to remove the pandemic-era stimulus and get back to the pre-Covid stance that they consider "neutral," instead of seeking to lean against current inflation. In the market's view, there are risks in this approach – moving too sharply could prove to be a mistake. A policy reversal has been priced in for the UK.

There are risks to our *new nominal* theme. Central banks could drop their new frameworks– although we see the bar for doing so as very high. And higher inflation could increasingly become a political issue or start to shape expectations of future inflation, putting pressure on central banks to adopt a more aggressive stance. And the journey to reach net-zero emissions by 2050 may be more chaotic than we expect, raising the specter of more inflation later. The widening gap between governments' ambition to cut emissions and implementation raises the risks of such a disorderly transition.

Bottom line: We see equities as a potential buffer against inflation because we expect a more muted response of yields to inflation than in the past. Real, or inflation-adjusted, yields should remain low or negative as a result, making equities attractive. In addition, many companies so far have been able to pass on higher input costs and keep their margins intact. We are overweight equities and inflation-linked bonds, and underweight nominal government bonds on both tactical and strategic horizons. Trading liquidity in bond markets has declined, resulting in exaggerated moves that add to the confusion of reading yield move signals. Stay tuned for our 2022 Global Outlook next month to hear our updated views.

Market backdrop

The U.S. CPI revived expectations for the Fed to start lifting interest rates from near zero as soon as June next year. We think the broader market pricing of higher policy rates is overdone – both in how soon key developed market central banks may lift rates and how quickly they will do so.

Assets in review

Selected asset performance, 2021 year-to-date 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 Nov. 11, 2021. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, 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, in descending order: spot Brent crude, MSCI USA Index, MSCI Europe Index, ICE U.S. Dollar Index (DXY), MSCI Emerging Markets Index, Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, spot gold, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index and Refinitiv Datastream U.S. 10-year benchmark government bond index.

Macro insights

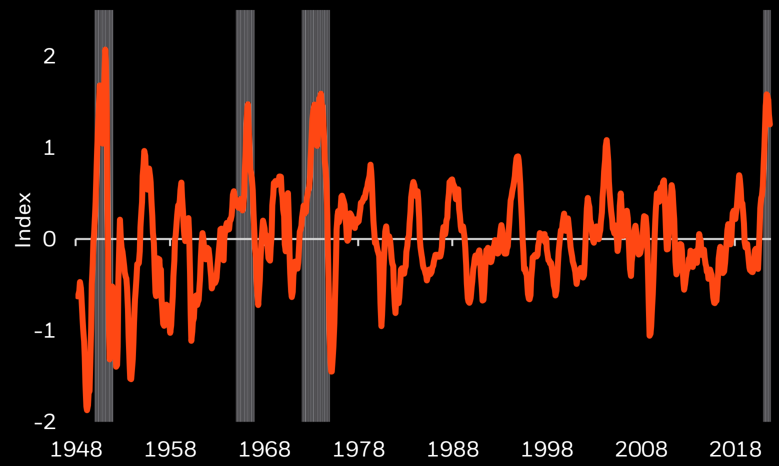
Current supply constraints are among the most severe of the last 75 years – see the chart – and are largely behind the high inflation prints we have seen over recent months. This unusual situation of supply-driven inflation is creating confusion among policymakers and markets. The usual logic for central banks to lean against inflation early doesn't apply.

Supply chain imbalances are the result of supply-related factors, including labor tightness, semiconductor shortages and transport bottlenecks. Extraordinary demand – fueled by goods consumption, accumulated household savings, rising capex and generous fiscal policy, particularly in the U.S. – is adding to supply pressures.

Demand looks set to remain robust in 2022, but we expect supply to gradually rise to meet demand as most bottlenecks dissolve and the powerful restart of economic activity runs its course. Large companies appear well positioned to manage through the disruptions thanks to their scale, preferential access to supplies, greater capital expenditure and pricing power. See our macro insights hub.

Supply constraints at historical highs

ISM manufacturing constraints indicator, 1948-2021



Sources: BlackRock Investment Institute, Institute for Supply Management, using data from Haver Analytics, November 2021. Note: Index of manufacturing supply chain constraints is based on ISM survey indicators: supplier delivery times, backlog of orders, prices paid and inventories. The grey bars highlight episodes of peak supply chain constraints.

Investment themes

1 The new nominal

- Inflation is being driven by the unusual restart dynamics, and will likely persist in 2022. We expect the supply-demand imbalances to resolve eventually next year. We see the *new nominal* theme continuing to play out in 2022.
- Policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation. Other developed market central banks, including the Bank of England, have signaled a policy rate path with much steeper initial increases. Market pricing suggests a policy reversal for the BoE.
- We have moved forward our expectation for the Fed to start raising interest rates to next year – if not as soon as the market pricing. But what matters is the overall policy rate trajectory, not just the first hike. We are expecting the most muted response of policy – and nominal government bond yields – to higher inflation in decades.
- The Fed said it will start tapering bond purchases this month, trimming them by $15 billion a month. The central bank may have achieved its new inflation mandate to make up for past misses, but will likely still keep rates low to achieve its more ambitious full employment mandate.
- **Tactical implication**: We are overweight European equities and inflation-linked bonds. We are neutral on U.S. equities. We are modestly overweight EM local-currency debt.
- **Strategic implication**: We remain underweight DM government bonds and prefer equities over credit.

2 China stands out

- China is on the path toward greater role of state where social objectives will have primacy over quantity of growth. Yet the growth slowdown has hit levels policymakers can no longer ignore and we expect to see incremental loosening across three pillars - monetary, fiscal and regulatory.
- We believe investors should be mindful of ongoing geopolitical tensions, which was underscored by the uncertainty around China's clampdown on certain industries.
- **Tactical implication:** We are modestly positive on Chinese equities, and maintain an overweight on its debt.
- **Strategic implication:** Given the small benchmark weights and typical client allocation to Chinese assets, allocation would have to increase by multiples before they represent a bullish bet on China, and even more for government bonds.

3 Journey to net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today. The net-zero journey is not just a 2050 story, it's a now story.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs, yet the economic outlook is unambiguously brighter than a scenario of no climate action.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions. Policy remains the main tool. Some carbon-heavy companies already are changing their business models, independent of regulatory and political outcomes, creating potential investment opportunities.
- We see sustainability-driven repricing as having just begun – with accelerating flows into ESG products a big driver. We expect sizeable dispersion in repricing returns. How the repricing evolves will be key in coming years.
- Certain commodities, such as copper and lithium, will likely see increased demand from the drive to net zero. Yet we think it's important to distinguish between near-term price drivers of some commodities – notably the economic restart – and the long-term transition that will matter to prices.
- **Tactical implication**: We are overweight the tech sector as we believe it is better positioned for the green transition.
- **Strategic implication**: We like DM equities and the tech sector as a way to play the climate transition.

Week ahead

Nov. 15	China industrial output, retail sales	**Nov. 17**	UK consumer price index
Nov. 16	U.S. retail sales; UK labor market data	**Nov. 18**	U.S. Philadelphia Fed index

October data from China will be in focus and is expected to show a deeper slowdown. We expect near-term easing on monetary, fiscal and regulatory policies to shore up growth. Investors will also watch inflation data from the UK to assess policy action ahead from the Bank of England. October U.S. retail sales should show how the strong payrolls recovery that month fed into consumer spending.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2021

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	**+1**	**+1**	We keep our overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a quality bias.
Credit	**-1**	**Neutral**	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt bonds	**-1**	**-1**	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Rising debt levels may eventually pose risks to the low rate regime. This is part of why we underweight government debt strategically. We prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		**Neutral**	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
Private markets	**Neutral**		We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.

Notes: Views are from a U.S. dollar perspective, October 2021. 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

Change in view

Previous → New

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, November 2021

	Asset	Underweight	Overweight	
Equities	United States			We are neutral U.S. equities. We see U.S. growth momentum peaking and expect other regions to be attractive ways to play the next leg of the restart as it broadens to other regions, notably Europe and Japan.
Equities	U.S. small caps			We stay overweight U.S. small-caps. We see potential in this segment of the U.S. equity market to benefit from the cyclical rebound in domestic activity brought about an accelerated vaccination rollout.
Equities	Europe			We stay overweight European equities on the back of a strong growth backdrop. We see a sizeable pickup in activity helped by accelerating vaccinations. Valuations remain attractive relative to history and investor inflows into the region are only just starting to pick up.
Equities	UK			We are neutral UK equities following their strong performance. We see the market as fairly valued and prefer European equities.
Equities	Japan			We are neutral Japanese equities. We see a global cyclical rebound helping boost earnings growth in the second-half of the year. The country's virus dynamics are also improving.
Equities	China			We are modestly positive to upgrade Chinese equities to overweight as we see a gradual dovish shift in monetary and fiscal policy in response to the cyclical slowdown and anticipate that the regulatory clampdown will become less intense.
Equities	Emerging markets			We are neutral EM equities. We see more uncertainty on the U.S. dollar outlook due to a risk premium from Fed communication. Many EMs have started tightening policy, showing less policy support and a greater risk of scarring.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. Potential knock-on effects from slower growth in China and broader geopolitical risks dampen the outlook, in our view.
Fixed Income	U.S. Treasuries			We are underweight U.S. Treasuries primarily on valuations. We see the balance of risks is for gradually higher yields as markets continue to price in the economic restart, especially given the pullback in yields in recent months.
Fixed Income	Treasury Inflation-Protected Securities			We are overweight U.S. TIPS. We believe the recent pullback in the asset class presents an attractive opportunity, particularly on a relative basis against European inflation breakevens as the outlook for euro area inflation remains sluggish.
Fixed Income	German bunds			We are neutral on bunds. Although the ECB may begin tapering this year given inflation dynamics, we see little room for a substantive change in policy in the near term.
Fixed Income	Euro area peripherals			We are neutral euro area peripheral government bonds despite recent outperformance given stability in ECB policy, low volatility in peripherals and better value elsewhere.
Fixed Income	China government bonds			We are overweight Chinese government bonds. We see the relatively stability of interest rates and the carry on offer as brightening their appeal.
Fixed Income	Global investment grade			We are underweight investment grade credit We see little room for further yield spread compression and favor more cyclical exposures such as Asian fixed income.
Fixed Income	Global high yield			We are neutral high yield after the asset class' strong performance. Spreads are now below where we see high yield as attractive valued. We prefer to take risk in equities.
Fixed Income	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
Fixed Income	Emerging market – local currency			We are modestly overweight local-currency EM debt. We believe the asset class offers attractive valuations and carry in a world starved for income.
Fixed Income	Asia fixed income			We are overweight Asia fixed income. Outside of China, we like Asia sovereigns and credit for their yield and income given the region's fundamental outlook.

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