Weekly commentary

November 21, 2022

BlackRock

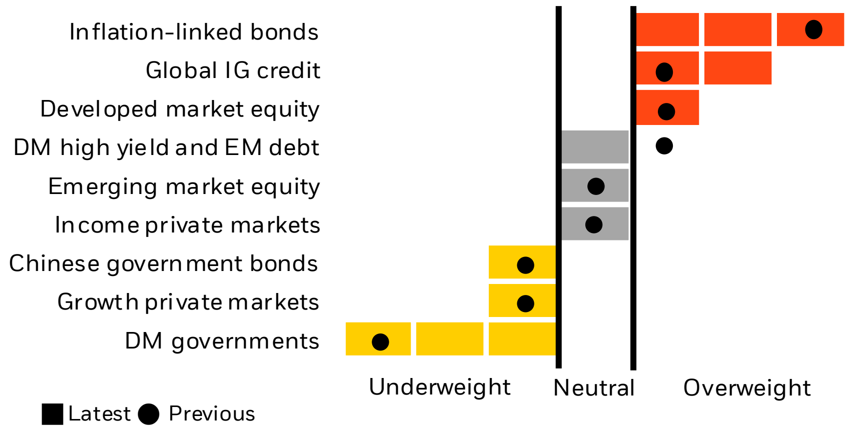
Strategic views in the new regime

- Strategic views are evolving in new regime. We lean into investment-grade credit and away from high yield. We stay overweight inflation-linked bonds and stocks.
- Stocks were flat and the yield curve further inverted last week. The Federal Reserve seems set on rate hikes, even as the damage is starting to be clear.
- Global manufacturing and services data should signal how economic activity is responding to central banks' policy tightening. We see recessions ahead.

Our strategic views of five years and longer are positioned for the new regime of greater macro and market volatility. We go more overweight investment grade (IG) credit on attractive yields and healthy corporate balance sheets that can withstand the mild recession we expect. We stay modestly overweight developed market (DM) equities. We expect the overall return of stocks over the coming decade to be greater than fixed-income assets even if equities take a near-term hit.

Leaning into investment grade credit

Strategic (long term) asset views, November 2022



Source: BlackRock Investment Institute, November 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 or a guarantee of future results.

Since our last strategic view update, we increased our overweight on global IG credit and cut high yield to neutral from overweight (see chart). We like the income we can pick up in IG at higher spreads. And we see looming recessions having more ripple effects on high yield than IG. Other views hold true as the new regime plays out. Our expectation of sticky inflation favors inflation-linked bonds not yet pricing in that view. Nominal long-term bonds are challenged for multiple reasons that we see driving a higher term premium, or the compensation for holding them. We prefer short-term government bonds because they don't face the same risks from investors demanding more term premia as in long-term bonds. Our modest overweight in DM stocks is because we think central banks will live with inflation, keeping recessions mild, and long-term valuations are fair.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The new regime warrants getting more granular than broad asset class views can convey - both between and within asset classes. For example, old correlations have broken down between equities and bonds that underpinned the bond role as portfolio ballast. We're underweight government bonds because we think investors will demand higher term premium amid higher inflation and elevated debt burdens. Within government bonds, we like short maturities to collect attractive coupons. We prefer to take fixed-income risk in credit – and prefer public credit to private. We like the income potential and strong balance sheets in IG where credit spreads are near the widest in two years. We're cautious on high yield and move to neutral – even mild recessions lead to greater defaults and downgrades in lower quality credit.

We stay overweight in inflation-linked bonds because we see persistent inflation – and we still like long-term inflation-linked bonds. Why? We think the new regime of production constraints is set to persist, reinforced by three big transitions. First, aging populations mean shrinking workforces – one reason why labor supply is struggling to keep up with output. Second, we think geopolitical fragmentation is rewiring supply chains. Efforts to re-shore operations could also add to the upward pressure on wages and inflation. Third, we see the transition to net-zero carbon emissions reshaping energy demand and supply over time. Yet market pricing shows expectations for inflation to slow back near pre-pandemic levels.

Over the next year, stocks don't yet fully reflect our recession expectation and the resulting drag on corporate earnings. That's why we're underweight tactically. But strategically we expect the overall return of stocks to be greater than fixed-income assets over the coming decade. That's partly because we see the politics of recession taking over from the politics of inflation – and central banks will eventually live with some inflation. Staying invested in stocks is one way to get more granular with structural trends impacting sectors. We think lower-carbon sectors like tech and healthcare will benefit more on average than traditional energy stocks in the transition to net-zero carbon emissions, even as traditional energy firms with credible transition plans can do well. In private markets, valuations have not caught up with the public market selloff, reducing their relative appeal. But we think private markets should be a larger allocation than what we see most qualified investors hold.

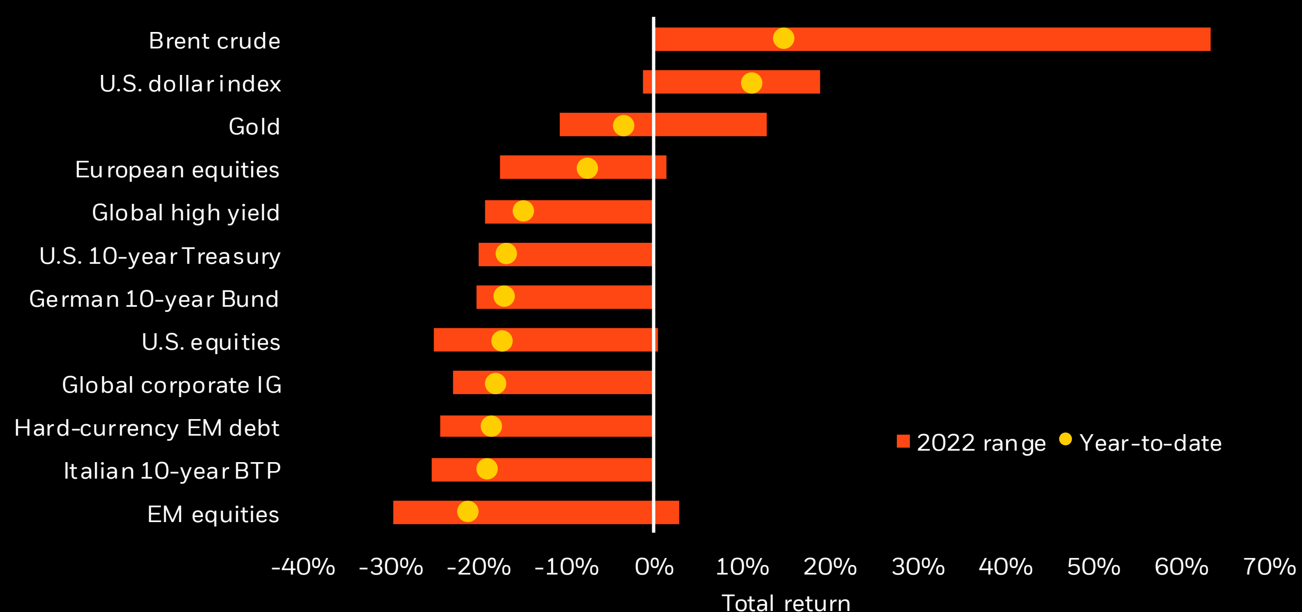
Bottom line: Our strategic views are positioned for the new regime of greater macro and market volatility. We think portfolios need to be more dynamic and change more frequently by constantly assessing the economic damage in market pricing. Watch for our updated views and more on navigating the new regime in our 2023 Outlook on Nov. 30.

Market backdrop

Stocks flatlined this week while the U.S. Treasury yield curve neared its most inverted levels since the early 1980s. Federal Reserve officials made clear that what matters is not the pace of rate hikes, but the end-point for policy rates. The Fed is set to overtighten policy, causing a mild recession, just as signs of damage become evident – such as a further drop in U.S. housing starts. We think the Fed will ultimately stop when the economic pain is clearer and live with some inflation.

Assets in review

Selected asset performance, 2022 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 Nov. 17, 2022. 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: 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.

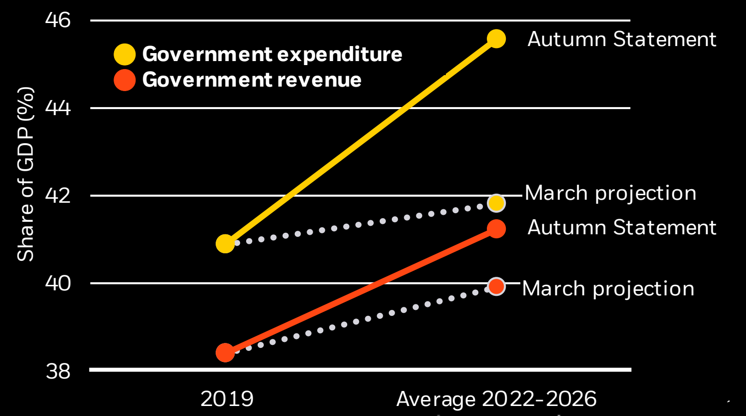
Macro take

Rebuilding credibility comes with economic costs. In last week's budget update, UK Chancellor Jeremy Hunt tried to restore market confidence in the government's ability to balance its books. He announced a raft of tax increases to fund higher government spending. See the chart. We expect the energy shock to restrict the UK's production capacity in the future. In a smaller economy, tax rates need to go up to bring in the same total tax revenue as before.

Even after accounting for these moves, we believe the UK is poised for a longer recession than the U.S. or euro area. The country is already in recession and the Bank of England is not yet done with its rate hikes – though we expect fewer than would have been the case had the government stuck to its previous plan of sweeping tax cuts and unfunded spending. That plan led to a destabilizing spike in UK government borrowing costs and illustrated how financial cracks can appear when interest rates and bond yields rise rapidly – a lesson for other countries, as we discussed in a previous macro take.

Tax hikes to restore credibility

UK government spending and revenue



Sources: BlackRock Investment Institute and Haver Analytics, November 2022. Note: The chart shows government expenditure (yellow) and revenue (orange) as a share of GDP. The 2019 data show actual revenue and borrowing in the fiscal year 2019, and the projected average for 2022-26 is based on projections from the OBR as of the March 2022 Economic and Fiscal Outlook (gray) and the November 2022 Economic and Fiscal Outlook (yellow/orange).

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage gives policymakers less maneuvering room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S., we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** We are tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a new world shaped by supply. Major spending shifts and production constraints are driving inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the energy shock and China's lockdowns.
- We are in a new macro regime where central banks are causing recessions rather than coming to the rescue. That is clear in the rate path of major central banks set to overtighten policy as they battle inflation. We think they will eventually pause but not cut rates when confronted with the damage of sharp rate hikes – that could be the reality of recession or the appearance of financial cracks, as seen in the UK.
- The Federal Reserve delivered another mega rate hike, as expected, but also signaled it would have to take rates higher than it originally planned, even if at a slower pace.
- The Bank of England has acknowledged some recession is necessary to get inflation down, yet like other central banks, it is failing to acknowledge the scale of the recession needed to get it all the way down to target.
- The ECB continues to normalize monetary policy, but a change in tone suggests it could be poised to slow the pace of hikes. We think the ECB is still raising rates into a recession triggered by the energy shock and its hikes.
- **Investment implication**: We are tactically underweight DM equities after having further trimmed risk.

3 Positioning for 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.
- We see a global drive for more energy security accelerating the transition in the medium term, especially in Europe.
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like sectors with clear transition plans. Over a strategic horizon, we like sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication**: Time horizon is key. We see tactical opportunities in selected energy stocks.

Week ahead

Nov. 22	Euro area flash consumer confidence	**Nov. 23**	Global flash PMIs; U.S. durable goods
Nov. 24	Germany IFO business survey		

This week's global PMIs take center stage as we gauge activity relative to the looming recession we expect in major economies. We don't see a soft landing outcome from central bank overtightening but think they will stop short of causing deep downturns as the damage from sharply higher rates becomes clearer.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, November 2022

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

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we see central banks ultimately choosing to live with some inflation. 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 (previous view: +1)	+1	Strategically, we add to our overweight to global investment grade on attractive valuations and income potential given higher yields. We turn neutral high yield as we see the asset class more vulnerable to recession risks. Tactically, we're also overweight investment grade and neutral high yield. We prefer to be up in quality. We overweight local-currency EM debt on attractive valuations. A large risk premium compensates investors for inflation risk, in our view.
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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, November 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings prospects.
Europe	-1	We are underweight European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like still-easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. Attractive carry spurs a preference for short-maturity bonds.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. The pullback in euro area breakeven rates since May suggests markets are underappreciating the inflationary pressures from the energy shock.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	Neutral	We are neutral UK gilts. Perceptions of fiscal credibility have improved, though not fully, after a reversal of planned fiscal stimulus. We think the BoE will have to hike rates less than we assumed immediately after the Sept. 23 "mini budget."
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
Emerging market – hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market – local currency	+1	We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view, and offer compensation for inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income 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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