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Weekly commentary

December 12, 2022

BlackRock

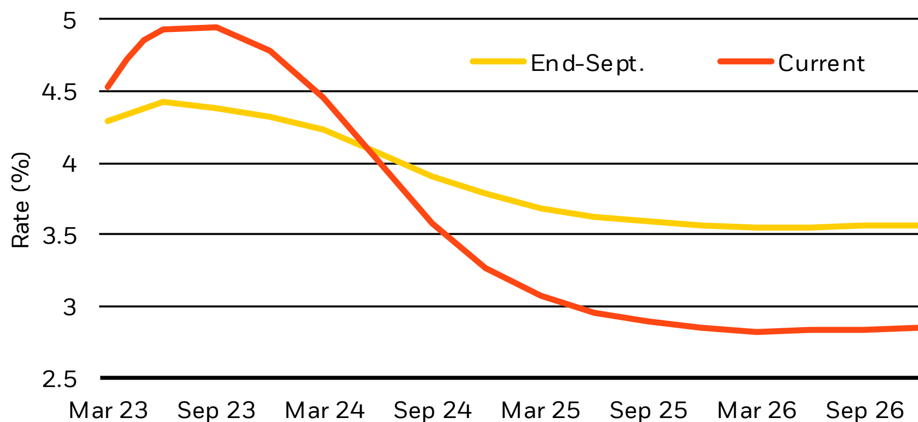
Don't be tempted by the old playbook

- Recession is foretold, in our view, as central banks crush demand to bring down inflation. We think markets are wrong to expect them to later come to the rescue.
- U.S. stocks fell and the Treasury yield curve inverted its most since the early 1980s. We see recent moves as reflecting hopes for the old recession playbook.
- Central banks are expected to slow the pace of hikes this week even if they stay historically large. We think rates are going to remain high once policy rates peak.

Major central banks will hike rates again this week: Getting inflation down means they need to crush demand, making recession foretold. We expect central banks to keep rates high as recession unfolds – not save the day as in the past. Yet Treasury yields have slid as the market expects Federal Reserve rate cuts, with the yield curve inverting more. We think that incorrectly reflects hopes for an old recession playbook and stay underweight developed market stocks and long-term bonds.

Old playbook expectations

Fed policy rate expectations, March 2023 – Sept. 2026



Sources: BlackRock Investment Institute, with data from Refinitiv, December 2022. Notes: The chart shows the market pricing of future U.S. policy rates based on SOFR futures. The dark orange line shows the path as of Dec. 6, 2022, versus the path as of Sept. 30, 2022, represented by the yellow line.

We think markets are pricing in rate cuts starting in mid-2023 (the dark orange line in the chart) because they think the Federal Reserve will ride to the rescue when recession hits – the old playbook. That view has made U.S. yield curves the most inverted since the Fed's last rapid hiking cycle in the 1980s, with five-year Treasury yields falling more than two- and 10-year yields over the past month. That's boosted stocks. We see core inflation falling further next year from current levels but think central banks won't be getting it back to 2% targets. Doing so would require an even deeper recession, in our view, and we see them stopping short of such an outcome as the damage from policy overtightening becomes clearer. So we see central banks living with persistently above-target inflation – and they won't be able to cut rates as quickly as markets expect, in our view.

Jean Boivin
Head – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Nicholas Fawcett
Macro research – BlackRock Investment Institute

Tara Sharma
Investment Strategist – BlackRock Investment Institute

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BlackRock **Investment** Institute

We're starting to see recessions developing. Fed hikes have caused U.S. housing sales to slump on surging mortgage rates while businesses cut investment plans. U.S. households have dipped into excess savings built up during the pandemic to fund spending: The U.S. savings rate hit a 17-year low in October, according to the U.S. Bureau of Economic Analysis. We estimate U.S. consumers could deplete their accumulated savings next year. We see spending slowing, worsening an already contracting economy, in our view. In Europe, we see higher rates adding to economic pain from the energy shock.

We expect inflation to fall significantly from its current highs as energy prices stabilize and goods inflation falls due to easing supply bottlenecks. Yet pushing inflation down to target would entail even deeper recessions, in our view. A case in point: Harder-to-solve constraints – like a labor shortage as workforces age – are driving the Fed's inflation headache. That means the U.S. economy can't sustain current activity levels without creating inflation pressure. We think the Fed would have to close the gap soon between where the economy is operating and where it can comfortably operate given these constraints. That's why we don't see central banks reversing course by cutting rates as recession plays out. They're now creating recessions, not riding to the rescue as they did in the past.

The U.S. equity rally and yield curve inversion show that markets are clinging to central banks' old recession playbook. Market hopes of easing have supported the equity rally despite Fed Chair Jerome Powell's message that rates may stay higher for longer. We think stocks could fall again if markets stop expecting policy easing. The gap between market expectations and the Fed's intentions will start to close over time, in our view. We see long-term yields surging as investors demand more term premium, or compensation for the risk of holding long-term bonds, amid persistently above-target and more volatile inflation, historically high rates, record debt levels and the risk of financial accidents. The UK gilt selloff gave a glimpse of the return of bond vigilantes. Any change to the Bank of Japan's yield curve control policy could add to a return of term premium.

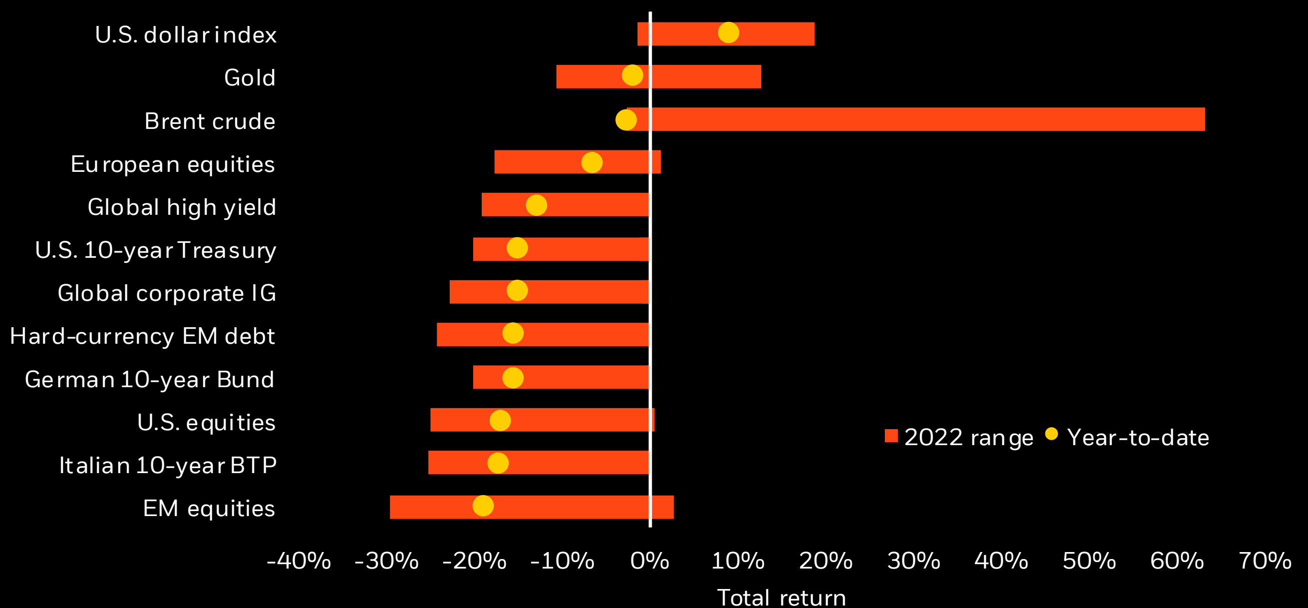
Our bottom line: We stick with our conviction that nominal government bonds won't help diversify portfolios right now and stay underweight long-term government bonds. We look to the short end, investment grade credit and U.S. agency mortgage-backed securities for income. We're underweight DM stocks because we think markets will price out rate cuts and earnings don't reflect the recession foretold. We expect to turn more positive on equities sometime in 2023, after gauging how markets are pricing the economic damage we see ahead and market risk sentiment. That's our new investment playbook.

Market backdrop

Stocks fell 3% last week and Treasury yields were largely unchanged even as the yield curve inverted to its deepest levels since the 1980s. We think market expectations for rate cuts had boosted stocks, and earnings don't yet reflect the recession we expect. Lower long-term yields reflect that markets are clinging to the old playbook – where central banks counter recessions and long-term bonds work as portfolio ballast – and not seeing the risks of term premium returning, in our view.

Assets in review

Selected asset performance, 2022 year-to-date return and range



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Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of Dec. 8, 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.

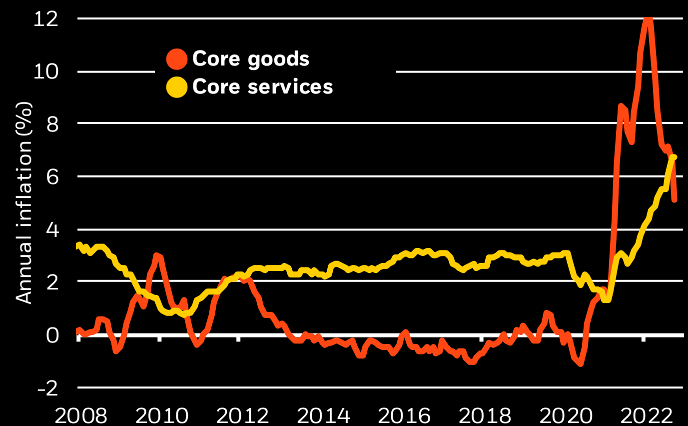
Macro take

The speed at which U.S. inflation falls from its current highs partly depends on how quickly consumer spending normalizes from a dramatic shift in the pandemic. A sudden splurge on goods pushed goods inflation up to 40-year highs. See the dark orange line on the chart. That has started to fall back in recent months as spending gradually rotates back to services. Services price inflation has also been rising, passing 40-year highs as well – and it's still climbing. See the yellow line. Services inflation also typically falls back more slowly than goods inflation.

The November U.S. CPI is due on Tuesday. We expect goods prices to fall over coming months – extending the decline in annualized goods inflation – as consumers continue to switch spending back towards services and retailers sell off stockpiled goods at discounted prices. But we think services inflation will stay elevated. Taken together, that means overall inflation is set to remain well above the Federal Reserve's 2% target for quite some time yet. Read all our latest blog posts here.

Services inflation looks persistent

U.S. core goods and services PCE inflation, 2008-2022



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, December 2022. Notes: The dark orange and yellow lines show core goods and services PCE inflation respectively, measured by the year-on-year percent change in price.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks race to try to tame inflation. It's the opposite of past recessions: Loose policy is 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. Surging mortgage rates have cratered 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.
- **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

Dec. 13	U.S. CPI	**Dec. 15**	European Central Bank (ECB) and Bank of England (BoE) policy decisions
Dec. 14	U.S. Fed policy decision; UK CPI		

Three major central bank policy decisions anchor the week. We think the Fed will keep rates higher for longer than the market is pricing. We see the ECB and BoE continuing to hike aggressively. We'll also be watching to see if central banks' quarterly forecasts are acknowledging the economic damage needed to bring inflation down to target.

Directional views

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

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.

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Granular views

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

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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