Weekly commentary

December 5, 2022

BlackRock

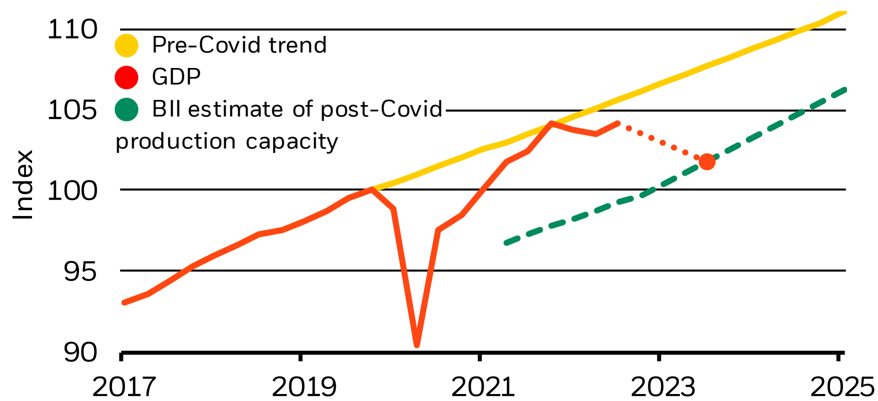
A new playbook for a new regime

- The new macro regime is playing out. We think that requires a new, dynamic playbook based on views of market risk appetite and pricing of macro damage.
- U.S. jobs data showed lower workforce participation is propping up wages and confirming labor shortages should help keep inflation persistently higher.
- We're watching services PMIs and key trade data for more signs of the damage from tighter financial conditions before key central bank meetings next week.

We see the new regime playing out and not going away. Persistent production constraints keep this regime of higher macro and market volatility in place, in our view. We think this means a new, dynamic playbook is needed – where tactical and strategic portfolios change more frequently to balance our views on risk appetite with the pricing of economic damage. It's also about granular views within sectors and asset classes of portfolios. Read more in our 2023 Global outlook.

Recession foretold

U.S. GDP and potential supply, 2017-2025



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, November 2022. Notes: The chart shows demand in the economy, measured by real GDP (in orange) and our estimate of pre-Covid trend growth (in yellow). The green dotted line shows our estimate of current production capacity. We infer that from how far core PCE inflation has exceeded the Federal Reserve's 2% inflation target.

We see a world shaped by supply that involves sharp trade-offs for central banks. Higher policy rates can't resolve limited production capacity (green line in chart) that we don't see changing soon. That means the only way for central banks to bring inflation down to target is to hike rates enough to crush demand (orange line) down to the level the economy can comfortably sustain. That's well below the pre-Covid growth trend (yellow line). Central banks appear set on doing "whatever it takes" to fight inflation, making recession foretold, in our view. We think a new playbook is needed – one that balances an assessment of overall risk appetite with estimates of the economic damage priced. Equities still don't reflect the damage we see ahead, so we're underweight. The trigger to turn positive is when the damage is priced, and visibility on the damage improves risk appetite.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Vivek Paul
Head of Portfolio Research – BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock Investment Institute

Our three investment themes help flesh out the new playbook. First, *pricing the damage*. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price. They are deliberately causing recessions and are unlikely to cut rates to cushion the impact. We stand ready to turn more positive as valuations get closer to reflecting economic damage – or if we think markets have enough clarity to sustainably dial up risk. But we won't see this as the beginning of another decade-long bull market in stocks and bonds. We're also *rethinking bonds*, our second theme. Fixed income finally offers attractive yield, especially in short-term government bonds and high-quality credit. But we don't think long-term government bonds will play the role of portfolio ballast: Inflation, central banks reducing their holdings and record debt levels will lead investors to demand more compensation for holding long-term bonds, or term premium. That leads us to our third theme: *living with inflation*. We see inflation cooling as spending patterns normalize and energy prices ebb – but we see it persisting above targets in the coming years.

A new playbook is important because three long-term drivers of production constraints mean the new regime isn't about to change, in our view. The first driver is aging. We see aging populations shrinking workforces and hitting growth. Second, a new world order. We think geopolitical fragmentation will lead to a rewiring of globalization and drive up production costs while also creating mismatches in supply and demand. Third, a faster transition to net-zero carbon emissions. We believe the global transition could accelerate, boosted by significant climate policy action, by technological progress reducing the cost of renewable energy and by shifting societal preferences as physical damage from climate change becomes more evident.

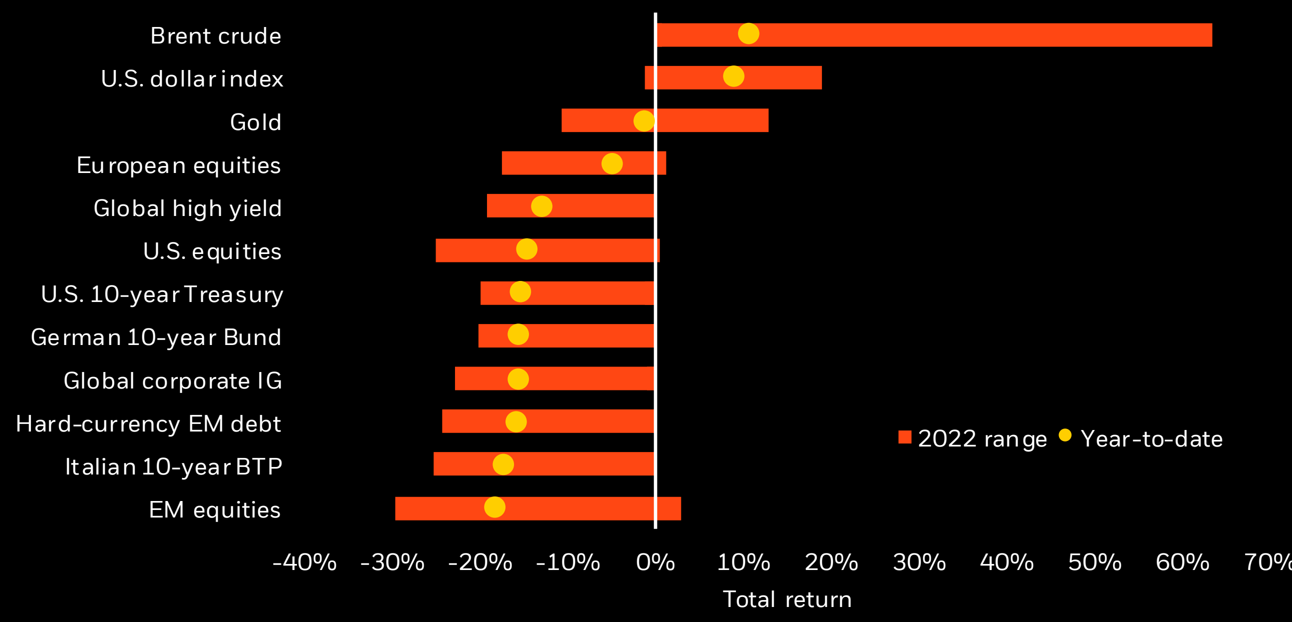
What does this all mean for portfolios? Our new investment playbook calls for more frequent portfolio changes and a granular approach. Take equities, we're tactically underweight developed market (DM) equities. They're not pricing the recession we see, but certain sectors are attractive, like healthcare. But we're neutral in Japan given still-easy monetary policy. Strategically, we're overweight DM stocks because we see better returns than fixed income over the coming decade. Within fixed income, we tactically like attractive income in investment-grade credit, U.S. agency mortgage-backed securities and short-term Treasuries. We stay underweight long-term government bonds though because we see investors demanding more term premium due to inflation and other risks. Our view that markets underappreciate the persistence of higher inflation underpins our high-conviction overweight to inflation-linked bonds, tactically and strategically.

Market backdrop

U.S jobs data showed wages rising twice as high as consensus forecasts and the labor force participation rate, or the share of the adult population in the workforce, ticking down. We think this shows how labor shortages are putting upward pressure on wages, likely keeping inflation persistently higher. That keeps the Federal Reserve on track to overtighten policy and trigger a recession, in our view. It also underscores why the Fed may keep rates higher for longer than markets expect.

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 Dec. 1 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

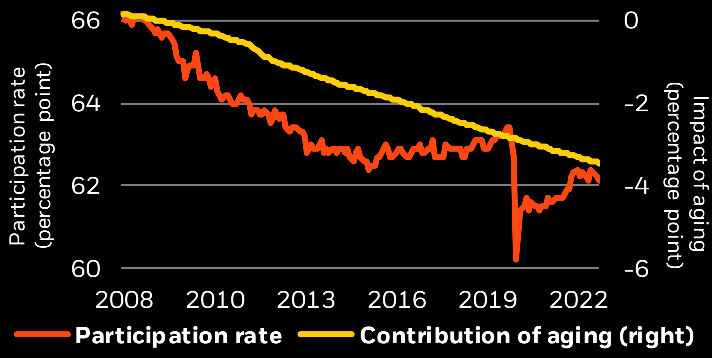
Friday's U.S. payrolls data confirmed that labor shortages are one of the key production constraints we see keeping inflation higher. In the U.S., an aging workforce is a contributor to such shortages that are keeping wage growth elevated – and higher core inflation sticky.

The labor force participation rate – the share of the adult population (16-years-old and over) inside the labor force – fell dramatically below pre-Covid levels. See the orange line in the chart. And many of those who left the workforce during the pandemic haven't come back.

The upward pressure on wages and inflation from labor shortages means the Federal Reserve would have to cause a severe recession if it wanted to get inflation back to its 2% target. We think the Fed will push ahead with rate hikes – leading to a recession foretold – and keep rates higher for longer as it seeks to drive down inflation. That was something Fed Chair Jerome Powell stressed last week but was overlooked as the market focused instead on his signal of a slower pace of hikes. Read all our latest blog posts here.

Labor shortages

U.S. labor force participation, 2008-2022



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics,, December 2022. Notes: The orange line shows the U.S. labor force participation rate, defined as the share of the adult population (16-years-old and over) that is in work or actively looking for work. The yellow line shows how much the aging population has contributed to the decline in the participation rate since 2008. It is calculated by fixing participation rates for each age group and changing the weights as observed in the population data over the chart sample period.

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. 5	U.S. and China services PMIs	**Dec. 7**	UK house prices; China trade
Dec. 6	U.S. trade; UK PMI	**Dec. 9**	University of Michigan consumer sentiment; U.S. and China PPIs

This week's services PMIs and trade data will be watched for signs of further damage from central banks' policy overtightening before next week's key meetings, including the Fed. The University of Michigan survey will again be scrutinized to see if consumer inflation expectations remain contained.

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 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 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 cut EM debt to neutral 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.

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, 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 turn 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 add to our 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 cut EM debt to neutral after it's 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.

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.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee