Weekly commentary

May 15, 2023

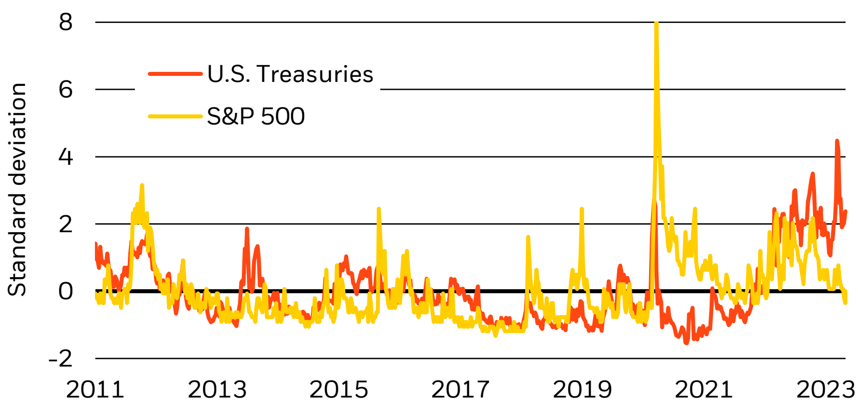
U.S. debt stand-off to add to volatility

- We think the U.S. debt limit showdown will spark renewed volatility in markets. That risk reinforces why we stay invested and cautious by going up in quality.
- Stocks were flat last week after U.S. data confirmed core inflation staying high. We think sticky inflation makes Federal Reserve rate cuts later this year unlikely.
- U.S. industrial production and business survey data due this week should gauge how the Fed's rate hikes have hurt industrial and business activity.

Negotiations to lift the U.S. debt ceiling are heating up. The Treasury hit the $31.4 trillion "ceiling," or cap on how much debt it can issue, in January. It may be unable to pay its bills in early June. Even if a deal is struck before then, we expect the debt showdown to stoke market volatility. The bigger story on a six- to 12-month horizon: We think central banks must damage growth to cool inflation in the new regime. We stay invested but cautious as a result, and favor quality assets.

Volatility brews

Bond and equity implied volatility, 2011-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, May 2023. Notes: The chart shows the normalized level of implied volatility for U.S. Treasuries and the S&P 500 in standard deviations as of May 5, 2023. The MOVE index represents U.S. Treasuries implied volatility, while the VIX index represents S&P 500 implied volatility.

A delay in lifting the U.S. debt limit, as well as the euro area debt crisis, spurred a bout of market volatility in 2011. See the chart. U.S. Treasury bill yields seen as the most vulnerable to late payment jumped, and the S&P 500 fell about 17% between July and August 2011. Policy rates were near zero back then, deflation risks were emerging and the Fed balance sheet was expanding. All that provided a cushion. The backdrop is very different today. Bond market volatility has already surpassed the 2011 level (dark orange line) as markets grapple with central banks' trade-off: either live with some inflation or crush economic activity. Equity volatility is more muted (yellow line). Yet we don't think stocks have been immune – just a few major tech stocks account for almost all S&P 500 returns this year. Our conclusion: Brace for higher volatility because of the combined effect of debt ceiling concerns and financial cracks from rate hikes.

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It's uncertain when exactly the U.S. Treasury will run out of funds to meet its financial obligations – known as the "X date." Treasury Secretary Janet Yellen has warned that could happen as soon as early June. Conversations about a last-minute deal to raise or suspend the debt ceiling, meaning eliminate it for a brief period, are ongoing as Democrats have so far rebuffed Republicans' push for spending cuts and other concessions. The Treasury risks a technical default when it temporarily fails to make its bond payments if policymakers don't strike a deal in time. The Treasury may prioritize paying bondholders over others, but it's unclear if the Treasury can do so: There is no precedent, and the Treasury lacks the legal authority. Yet there is precedent for credit rating agencies trimming the U.S. top-notch credit rating like S&P did in 2011 – even if a technical default doesn't happen. That could cause investors to demand more compensation for holding U.S. assets amid higher risk.

Yields for some Treasury bills maturing just after the X date have already started to rise, but risk assets have yet to fully react. Yields for the affected Treasury bills could march higher, and volatility may keep cycling through assets if the debt ceiling is repeatedly suspended.

We stay invested but cautious against this backdrop. We had already been going up in quality and focused on building resilient portfolios as the Fed rapidly hiked rates. We see opportunities to earn attractive income in short-term debt if yields rise more. Investors who don't need to quickly sell assets can earn attractive income during the debt showdown, in our view, by holding on to at-risk Treasury bills until they mature. Persistent inflation makes inflation-linked bonds attractive, too. Notably, demand for gold has picked up via exchange-traded funds and foreign exchange reserve managers.

Developed market equities remain the bulk of portfolio allocations, even as we underweight them slightly in the short term. We prefer emerging market (EM) stocks in the short term as they benefit from China's economic restart, EM central banks nearing the end of their hiking cycles and a broadly weaker U.S. dollar. We could consider leaning more into equities overall if debt ceiling volatility and recession create a sharp fall in equity prices.

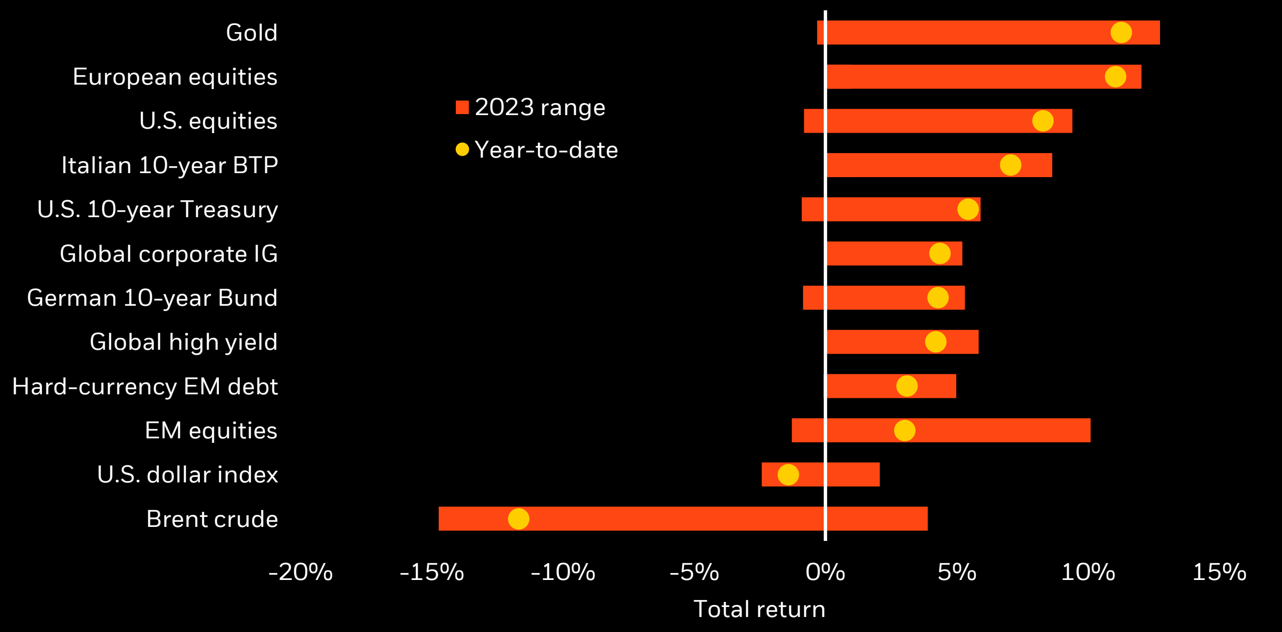
Bottom line: The debt ceiling showdown is set to increase the volatility in financial markets that has defined the new regime. Any selloff may cause risk assets to better price in the economic damage we expect from interest rate hikes. We're ready to shift our views on a six- to 12-month horizon to take advantage of opportunities that may appear.

Market backdrop

Global stocks were largely unchanged last week and bond yields stayed within their range since mid-March. U.S. CPI data showed that core services inflation, excluding shelter, is easing, but core goods prices surprisingly ticked higher. Core inflation still doesn't look on track to settle near the Fed's 2% target, making Fed rate cuts this year unlikely, in our view. The Bank of England hiked policy rates to 4.5% as it carries on with its fight against stubborn inflation while growth stagnates.

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 May 11, 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.

Macro take

We're expecting U.S. inflation to settle between 3-4% by the end of 2023. That assumes goods prices will cool as spending shifts back to services and higher interest rates soften the labor market, subduing wage growth.

But last week's April CPI data showed that core goods prices surged and core services inflation excluding shelter stayed sticky through the last three months. That means annual core inflation is running close to 5% in the three months to April – too high for the Federal Reserve. See the chart.

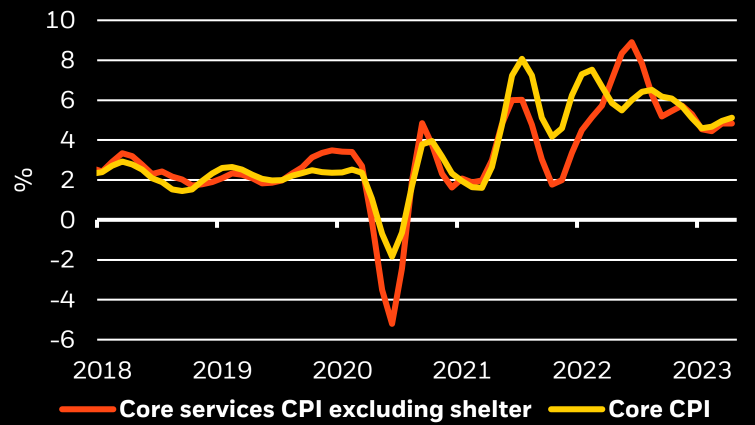
The one glimmer of hope? Core services inflation excluding shelter did decline in April – but we would need to see that decline extend over a longer period to prove that underlying inflationary pressures are easing.

The persistence of inflation is why we don't expect the Fed to cut rates in 2023. We think the effects of higher interest rates – amplified by credit tightening due to rate hikes – should ease inflationary pressures later this year.

Explore our recent Macro take blog posts here.

Elevated core inflation

U.S. three-month-on-three-month CPI inflation, 2018-2023



Source: U.S. Bureau of Labor Statistics, with data from Haver Analytics, May 2023. Notes: The chart shows inflation rates for services CPI excluding energy, rent of primary residence and owner-equivalent rent (core services CPI excluding shelter) and all items excluding food and energy (core CPI). Both lines show the percent change in the three-month average price level over the preceding three months, expressed in annualized terms.

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.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **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 Fed's 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

May 16	U.S. industrial production, retail sales; Germany ZEW economic sentiment
May 18	U.S. Philly Fed Index
May 19	Japan CPI

We're watching industrial production and business survey data in the U.S. to gauge the damage to activity as higher interest rates tighten financial conditions and cause financial cracks, as seen in bank turmoil. We're also looking for signs of a sustained rise in Japan inflation that we think may eventually spur a change in ultra-loose policy – and bond volatility.

Directional views

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

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 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.
	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.
	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.
	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	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.
	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.
	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.
	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.
	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.
	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	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.
	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	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.
	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.
	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.
	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	+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.
	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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