

Weekly commentary

February 21, 2023

BlackRock

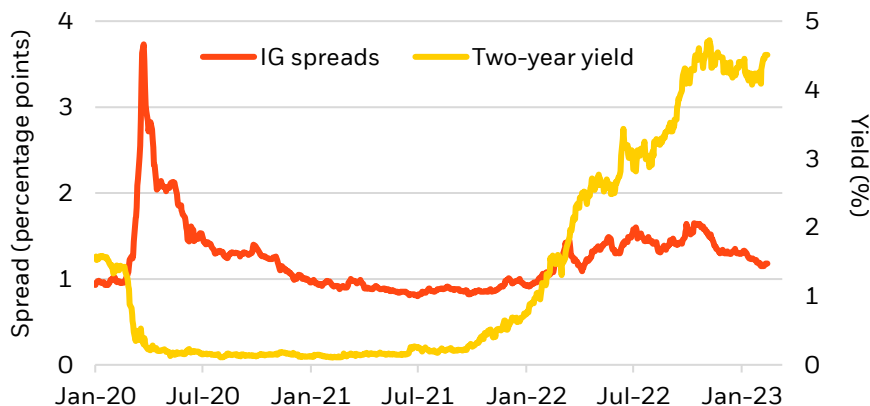
Seeking income and staying nimble

- Markets are waking up to our expectation of more central bank rate hikes as inflation proves sticky. We go overweight U.S. short-term bonds for income.
- U.S. two-year Treasury yields jumped near 15-year highs – sparking an equity retreat – as Federal Reserve rate cuts later in the year were priced out.
- Flash PMIs will show if activity is proving resilient at the start of the year. The PCE inflation data may confirm core inflation is staying persistently high.

We entered 2023 arguing the new macro regime required more nimble portfolios. A risk asset rally has stalled while markets have come around to our view of central banks hiking rates further to fight stickier inflation. This year's moves prompt a tweak to our tactical views. We favor short-term government bonds for income. We trim our overweight to credit after spreads tightened. We go overweight emerging market (EM) stocks, adding to our relative preference over developed markets.

Yield is back

U.S. investment grade spreads and two-year Treasury yields, 2020-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2023. Notes: The chart shows the spread of U.S. investment grade corporate bonds over U.S. Treasury yields (dark orange line) and the two-year U.S. Treasury yield (yellow line).

Risk assets have jumped to start 2023 thanks to falling inflation, Europe's easing energy shock, China's rapid restart from Covid restrictions and technical factors that drove the quick move up. Yet we think the rally also reflects hopes that the sharpest central bank policy tightening in decades can avoid economic damage: growth will be sustained even if rates stay higher, and inflation will drop to 2% targets. Central banks then wouldn't need to further tighten policy and create recessions to lower inflation. Now bond markets are waking up to the risk the Fed hikes rates higher and holds them there for longer. We boost our allocation to short-term government bonds on our six- to 12-month tactical horizon to take advantage of higher yields. See the chart. We balance that by reducing our overweight to investment grade credit. We go overweight EM equities and prefer them over DM equities, partly to get exposure to China's rapid restart.



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This is not a typical economic cycle – and that’s why we have argued a new investment playbook is needed. Recent data has shown that U.S. economic activity is holding up. Core inflation is proving stickier than many expected as confirmed by recent U.S. CPI data and revisions. The U.S. labor market remains tight with unemployment at its lowest in five decades. We don’t think inflation is on track to return to policy targets – and a recession would be needed to get it down. That means solid activity data should be viewed through its implications for inflation. In other words: Good news on growth now implies that more policy tightening and weaker growth later is needed to cool inflation. That’s bad news for risk assets, in our view.

We increase short-term Treasuries to an overweight. The jump in yields – the two-year U.S. Treasury yield is now near 4.6% compared with 1.5% a year ago – that now means short-term bonds provide income. We also like their ability to preserve capital at higher yields in this more volatile macro and market regime. We reduce our overweight to investment grade credit. Credit spreads have tightened sharply along with stocks pushing higher, reducing their relative attraction. We remain moderately overweight and still think highly rated companies will weather a mild recession well given stronger balance sheets compared with before the pandemic. We also cut agency mortgage-backed securities to neutral due to the spread tightening.

We have had a relative preference for EM equities over developed markets (DM) for some time. We add to this relative preference by going overweight EM. We prefer EM as their risks are better priced: EM central banks are near the peak of their rate hikes, the U.S. dollar is broadly weaker in recent months and China’s restart is playing out. That is in contrast to major economies that have yet to feel the full impact of central bank rate hikes – and yet still have a too-rosy earnings outlook, in our view. Plus, the risk is growing that DM central banks press ahead with more rate hikes. We see risks in EMs, too, but think they are better priced for now. EM equities would not be immune to any resulting risk asset selloff and U.S. dollar surge if the Fed keeps hiking rates. And China’s restart – like those seen in DM economies – doesn’t change the long-term drags on growth it faces. Investors are still requiring more compensation for the geopolitical risk of holding Chinese assets – which has risen, in our view – and also considering risks from regulatory and government intervention.

Bottom line: We put into practice our new playbook of making more frequent changes to our tactical asset allocation. We lean further into short-term government bonds and our preference for EM equities over DM. We trim our overweight to investment grade credit and turn neutral on agency mortgage-backed securities.

Market backdrop

Two-year U.S. Treasury yields surged back near 15-year highs as markets priced out Fed rate cuts this year. The yield curve between two- and 10-year Treasuries inverted further to its most extreme levels since the early 1980s. The yield jump sparked a broad retreat in equities, with the S&P 500 falling for a second straight week. We think investors are realizing that sticky core inflation may mean the Fed hikes rates further – and holds them there for longer – than markets had expected.

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 Feb. 17, 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

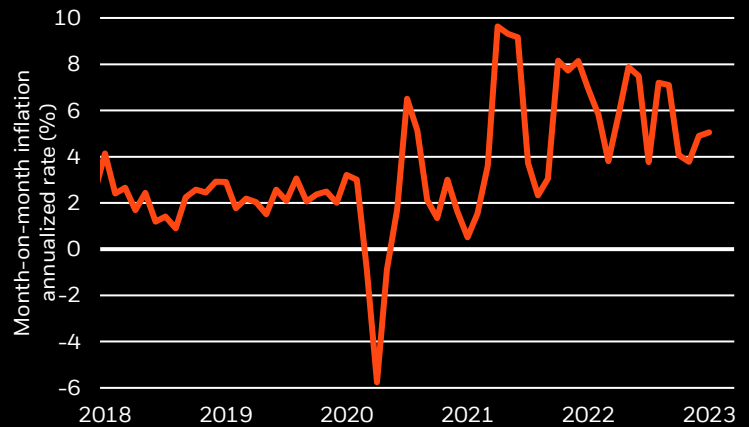
A surprisingly strong inflation reading last week shows U.S. inflation is proving very persistent. The monthly change in the core consumer price index (CPI) – which excludes more volatile food and energy prices – rose to an annualized 5%. See the chart. That was mostly driven by services. But goods prices, which had recently started to decline, rose again.

What's behind this? We believe it's all about the labor market. A worker shortage means firms are having to raise wages a lot to recruit and retain staff. Strong wage growth is pushing up overall inflation. We don't think the shortage will resolve anytime soon, so chances are slim that wage pressures will ease enough that inflation falls back to the Fed's 2% target on its own accord.

What can the Fed do? It is already rapidly raising interest rates to slow economic activity and ease the pressure in the labor market. But if inflation persists and activity can withstand those hikes, it may need to raise rates further – and keep them higher for longer – than markets currently expect. Explore our latest [blog posts](#) for more on this topic.

Inflation proving persistent

U.S. core CPI inflation, 2018-2023



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, February 2023. Notes: The chart shows U.S. core CPI inflation – which excludes energy and food – based on month-on-month changes in seasonally-adjusted prices, expressed as an annualized rate.

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 most evident in 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.
- In Europe, tighter financial conditions are biting even as the energy shock eases.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think they will halt rate hikes once the economic damage becomes clear.
- **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.
- Short-term government debt looks more attractive for income at current yields, and we like their ability to preserve capital. We like investment-grade credit and think it can hold up in a recession, with companies having fortified their balance sheets by refinancing debt at lower 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 short-term government bonds and 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. 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

Feb. 21

Global flash PMIs

Feb. 24

U.S. PCE inflation and spending

Feb. 23

U.S. jobless claims

We're looking at flash PMIs in the U.S. and Europe for more signs of resilience. Stronger activity could reinforce expectations that further central bank tightening could be needed to bring inflation down to policy targets. We're also watching the U.S. PCE report for confirmation of stickier core inflation as seen in the U.S. CPI.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, February 2023

	Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view		Tactical view	
Equities	<p>+1</p>		<p>-1</p> <p>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 cause economic damage with their rate hikes. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight and have a relative preference for EM stocks due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.</p>	
Credit	<p>+1</p>		<p>+1</p> <p>Strategically, we stay overweight global investment grade but reduce 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 stay overweight investment grade but have also reduced it. We are neutral high yield and prefer to be up in quality. We are neutral EM debt after its strong run. We see better opportunities for income in DMs.</p>	
Govt bonds	<p>-1</p>		<p>-1</p> <p>The underweight in our strategic view on government bonds reflects a big spread: underweight nominal and max overweight inflation-linked. 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. We favor short-dated government bonds both strategically and tactically: Higher yields now offer relatively attractive income with limited risk from interest rate swings.</p>	
Private markets	<p>-1</p>		<p>—</p> <p>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.</p>	

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, February 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary
Equities	Developed markets	<p style="text-align: center;">-1</p> <p>We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy, financials and healthcare.</p>
	United States	<p style="text-align: center;">-1</p> <p>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.</p>
	Europe	<p style="text-align: center;">-1</p> <p>We are underweight. The energy price shock and policy tightening raise stagflation risks.</p>
	UK	<p style="text-align: center;">-1</p> <p>We are underweight. We find valuations expensive after their strong relative performance versus other developed markets thanks to energy sector exposure.</p>
	Japan	<p style="text-align: center;">-1</p> <p>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.</p>
	Emerging markets	<p style="text-align: center;">+1</p> <p>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.</p>
	China	<p style="text-align: center;">+1</p> <p>We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.</p>
	Asia ex-Japan	<p style="text-align: center;">Neutral</p> <p>We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.</p>
	Long U.S. Treasuries	<p style="text-align: center;">-1</p> <p>We are underweight. We see long-term yields moving up further as investors demand a greater term premium.</p>
	Short U.S. Treasuries	<p style="text-align: center;">+2</p> <p>We are overweight. We prefer short-term government bonds for income in this environment given the rise in yields and limited exposure to interest rate swings.</p>
Fixed Income	Global inflation-linked bonds	<p style="text-align: center;">+1</p> <p>We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.</p>
	Euro area govt bonds	<p style="text-align: center;">-1</p> <p>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.</p>
	UK gilts	<p style="text-align: center;">-1</p> <p>We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.</p>
	China govt bonds	<p style="text-align: center;">Neutral</p> <p>We are neutral. We find their yield levels less attractive than those on DM short-term government bonds.</p>
	Global IG credit	<p style="text-align: center;">+1</p> <p>We trim our overweight. Spreads have tightened this year. But we think strong balance sheets imply IG credit could weather a recession better than stocks.</p>
	U.S. agency MBS	<p style="text-align: center;">Neutral</p> <p>We are neutral. We see the asset class as a high-quality exposure within a diversified bond allocation. But tighter spreads make valuations less compelling.</p>
	Global high yield	<p style="text-align: center;">Neutral</p> <p>We are neutral. We prefer up-in-quality credit exposures.</p>
	Emerging hard currency	<p style="text-align: center;">Neutral</p> <p>We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.</p>
	Emerging local currency	<p style="text-align: center;">Neutral</p> <p>We are neutral EM debt after its strong run. We see better opportunities for income in DMs.</p>
	Asia fixed income	<p style="text-align: center;">Neutral</p> <p>We are neutral. We don't find valuations compelling enough yet to turn more positive.</p>

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