Weekly commentary

BlackRock

February 27, 2023

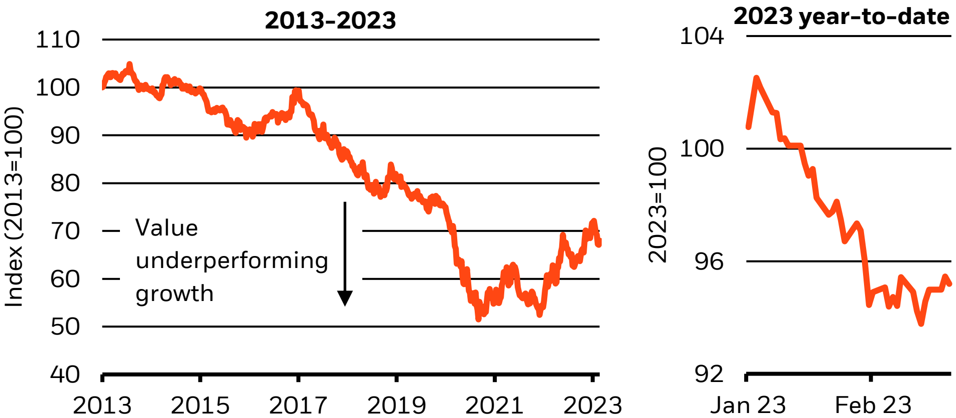
Pockets of value in stocks as rates rise

- We think value stocks can outperform as interest rates head higher. Regions and sectors help us find quality within value and growth at a reasonable price.
- Stocks slid after the Federal Reserve's preferred inflation gauge showed persistently high inflation, reinforcing why we see more rate hikes ahead.
- We see a tight labor market in the euro area keeping core inflation elevated. China's services PMI should show the economy's rapid restart is playing out.

Growth stocks have led the U.S. equity rally so far this year, halting outperformance in 2022 by value equities. We believe value stocks can resume their climb as major central banks keep interest rates higher for longer. Higher rates reduce the value of future cash flows, weighing more on growth stocks and reinforcing our developed market equities underweight. Underneath that, our sector and region preferences tilt to value with quality attributes and growth at a reasonable price.

Value vs. growth

Russell 1000 Value index relative to Growth, 2013-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, February 2023. Notes: The chart shows the U.S. Russell 1000 Value total return index divided by the U.S. Russell 1000 Growth total return index.

The new regime is not a typical business cycle and requires a new playbook. That applies to equity style factors, too, in our view. Value stocks – or those seen as undervalued relative to fundamentals – lagged growth stocks for much of the past decade (left chart). That switched abruptly in 2022 when central banks started rapidly tightening policy – only to be followed by a value dip early this year on hopes for policy easing (right chart). We think value can regain the lead. Why? Higher interest rates and inflation, and a steeper yield curve. That all favors value over growth, in our view. It's not about choosing one factor over another: Factors mean different things to different people, and the composition of factors also changes over time. Case in point: The healthcare sector is now a modest overweight in the MSCI USA Value index compared with an underweight in 2008.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Our macro view supports a case for value over growth. Higher interest rates feed into higher discount rates, making future cash flows of growth stocks less attractive. We also think persistent inflation is likely to lead investors to demand more compensation for holding long-term government bonds, driving yields higher. Value tends to outperform when the yield curve steepens, we find. While value historically underperforms heading into recession because capital-intensive companies can't respond quickly to changing cycles, we think that could be different in this atypical economic cycle. Value is still attractive after being beaten down for so long. Companies in the value bucket have also had time to prepare for a well-telegraphed downturn. Case in point: Many banks have already provisioned for losses in advance of a recession. Lastly, we expect a mild recession, so we think the performance impact is likely to be softer on value companies than in past cycles.

Our current asset allocations across regions and sectors have a value tilt with quality characteristics. We find that emerging markets (EM) and Europe have a consistent value bias when looking at the composition of indexes and key company metrics. For sectors, we see energy as a fusion of value and quality. We find value in the sector after being unloved and undisciplined with capital in the past. We think its stronger balance sheets, better investor payouts and improved return on equity give it more of a quality tilt. We find value in financials as well, but not the same quality. We see the sector capitalizing on higher rates with improved net interest margins after years of ultra-low or negative rates in some cases.

Healthcare has become more of a value sector but also has characteristics of growth. This speaks again to how factors can have different meanings and evolve over time. We like healthcare for its growth prospects but at the right price – valuations look reasonable to us relative to other growth sectors. We also see quality in healthcare's defensive characteristics during a recession and think aging populations bolster structural growth in demand.

Bottom line: We prefer to be selective within our cautious view of developed market equities. We like sectors and regions with a value bent while we stay nimble in this new regime of heightened macro and market volatility. We think structurally higher inflation, higher-for-longer interest rates and our expectation for a steeper yield curve all favor value. We find value in the energy and financial sectors and focus on quality within these sectors. We also like healthcare but at a reasonable price.

Market backdrop

Global stocks retreated further this week, with European equities faring better than U.S. peers. Short-term U.S. yields jumped to a 16-year high, with the yield curve at its most inverted since the early 1980s. The U.S. PCE inflation data showed stubbornly high core inflation. This reinforces our view that sticky inflation likely means major central banks will have to hike rates further and keep them higher for longer to bring it back down to their 2% targets.

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. 23, 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 see China's growth-focused policy shift – motivated by a deep exports slump – resulting in GDP growth just north of 6% this year. That's strong, but not all that strong considering the country is restarting after extended Covid lockdowns. The restart is also likely to be a one-off boost as we've seen elsewhere in the world.

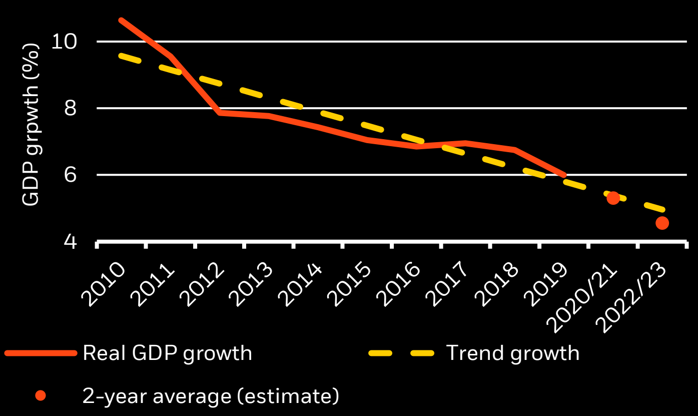
Beyond the restart, we think longer-term trend growth – yellow dotted line in chart – will be much slower than the pace seen pre-pandemic. Why? We see two reasons.

First, an aging and shrinking population means fewer workers. That limits how much the country can produce and grow – unless productivity increases at a faster rate.

Second, heightened geopolitical risks, strategic competition with the U.S. and strict regulation of companies in China could impede implementation of structural reforms and the productivity improvements needed to boost long-term trend growth. Explore our latest Macro take blog posts for more on this topic.

China growth: trending lower

Real GDP growth vs. estimated trend growth, 2010-2023



Sources: BlackRock Investment Institute, National Bureau of Statistics, February 2023. Notes: The orange line shows real GDP growth. The orange dots show the average growth over two years: 2020-2021 and 2022-2023, the latter taking our growth forecast for 2023.

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. 28	U.S. consumer confidence	**March 2**	Euro area unemployment and flash inflation
March 1	U.S. ISM manufacturing PMI	**March 3**	China Caixin services PMI

Euro area inflation data this week will be key for gauging how much higher the European Central Bank might lift policy rates. We're also watching unemployment data for signs of further labor market tightness that could stoke persistently high core inflation. China's services PMI will help assess how rapid the economy's restart has been.

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	+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 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.
Credit	+1	+1	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 are 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.
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, February 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, 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 developed markets thanks to energy sector exposure.
	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 short-term government bonds for income in this environment given the rise in yields and limited exposure to interest rate swings.
	Global inflation-linked bonds	+1	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
	Euro area govt 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 govt bonds	Neutral	We are neutral. We find their yield levels less attractive than those on DM short-term government bonds.
	Global IG credit	+1	We are overweight. Spreads have tightened this year. But we think strong balance sheets imply IG credit could weather a recession better than stocks.
	U.S. agency MBS	Neutral	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.
	Global high yield	Neutral	We are neutral. We prefer up-in-quality credit exposures.
	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. We don't find valuations compelling enough yet to turn more positive.

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