Weekly commentary

May 30, 2023

Markets now accept rate cuts unlikely

- Inflation has proven sticky, even as growth weakens. Markets are realizing that policy rates are set to stay higher for longer. We like quality in stocks and bonds.
- Tech stocks surged further last week even as debt ceiling talks spurred bouts of volatility. Long-term bond yields climbed on still hot U.S. inflation in April.
- U.S. jobs data this week should show a tight labor market is keeping wage pressures elevated. We think that keeps inflation sticky and above policy targets.

We've been saying since the end of 2022 that rate cuts this year would be unlikely as inflation sticks around. Markets are waking up to our view as a look under the hood reveals signs of weaker growth in major economies and market weakness due to rate hikes. Debt ceiling talks and the U.S. Treasury potentially being unable to pay its bills by early June have added to recent market volatility. We like quality in portfolios. We upgrade UK gilts to neutral as yields price in more rate hikes.

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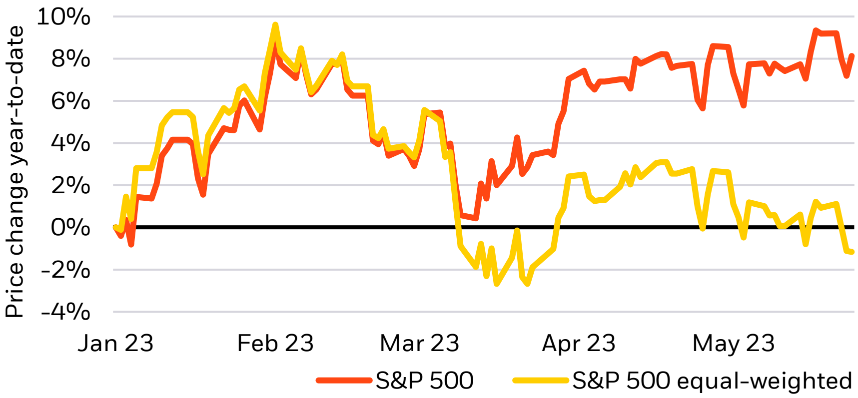
A big divergence

U.S. equities market cap vs. equal weighted price change year-to-date



Source: BlackRock Investment Institute, with data from Refintiv Datastream, May 2023. Notes: The chart shows the price index change for the S&P 500 Composite Index (market-capitalization weighted) and S&P 500 Equal-weighted Index since the start of 2023 through May 25, 2023.

Stubbornly high inflation has prompted the Fed's fastest rate hike campaign since the 1980s. Markets are no longer pricing in repeated Fed rate cuts, a sign they're grasping inflation's persistence, in our view. And the full effect of central banks' rate hikes is kicking in. Data last week showed Germany has entered recession even with a smaller-than-feared energy shock. In the U.S., GDP has held up but it has arguably entered recession based on gross domestic income, which assesses the economy's performance on an income rather than spending basis. A deeper look reveals stocks reflect worsening growth: The S&P 500 index was up nearly 10% so far this year (dark orange line in the chart). But a few large technology firms valued above $200 billion are driving those gains as they benefit from artificial intelligence buzz. Applying equal weighting to all companies in the index regardless of size shows it's down over 1% this year (yellow line) – extending 2022's hefty losses.

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Inflation and wage growth remain sticky, even with this deteriorating growth picture. Why? U.S. consumer spending's shift back to services from goods caused core inflation to fall at first. Yet labor constraints persist, with unemployment still near historic lows. We think tight labor markets are keeping wage gains high, making overall inflation stubborn. April PCE inflation data out last week confirmed that. Inflation is running even hotter in Europe, especially the UK. Central banks face a clear trade-off, in our view: crush activity to ease labor constraints and curb inflation – or live with some above-target inflation.

We see the Fed nearing a pause in rate hikes and living with some inflation to avoid the deep recession needed to get inflation near its target. But we don't see the Fed coming to the rescue of a faltering economy with rate cuts later this year due to the sharp trade-off between inflation and growth. Markets are coming around to our long-held view after having until recently priced in repeated rate cuts in 2023. We think the European Central Bank will hike more, regardless of the economic damage. The Bank of England (BOE) is in a similar position. Markets have priced in as many as four more BOE hikes. We think that might be a bit overdone, as it would be equivalent to the Fed hiking to around 7-7.5% – enough to trigger a severe recession.

We have a relative preference for UK gilts given this outlook. We close our previous underweight on UK gilts as yields return near levels reached during last September's turmoil. We favor quality in our portfolio. We're neutral investment grade credit and think yields above 5% compensate for wider spreads due to any downturn. We're overweight emerging market (EM) local currency debt given peaking EM rates and a broadly weaker U.S. dollar. We also look for quality in equities, with a preference for companies that are able to grow their earnings and wield pricing power to pass on higher costs. Cushioning portfolios from inflation is also key. We like inflation-linked bonds as markets underestimate the persistence of U.S. inflation but better appreciate it in Europe, we think. On a strategic horizon of five years or more, we lean into real assets that can buffer inflation like infrastructure and industrial properties. Strategically, we see returns for developed market (DM) stocks above bonds' as growth returns and inflation lingers in the U.S. DM stocks look riskier to us in the near term than fixed income given current yields. Debt ceiling concerns have upped market volatility, but we see the growth-inflation trade-off as a bigger driver of volatility longer term. We prefer EM stocks as they better price in the damage, yet China's growth stalling would pose risks.

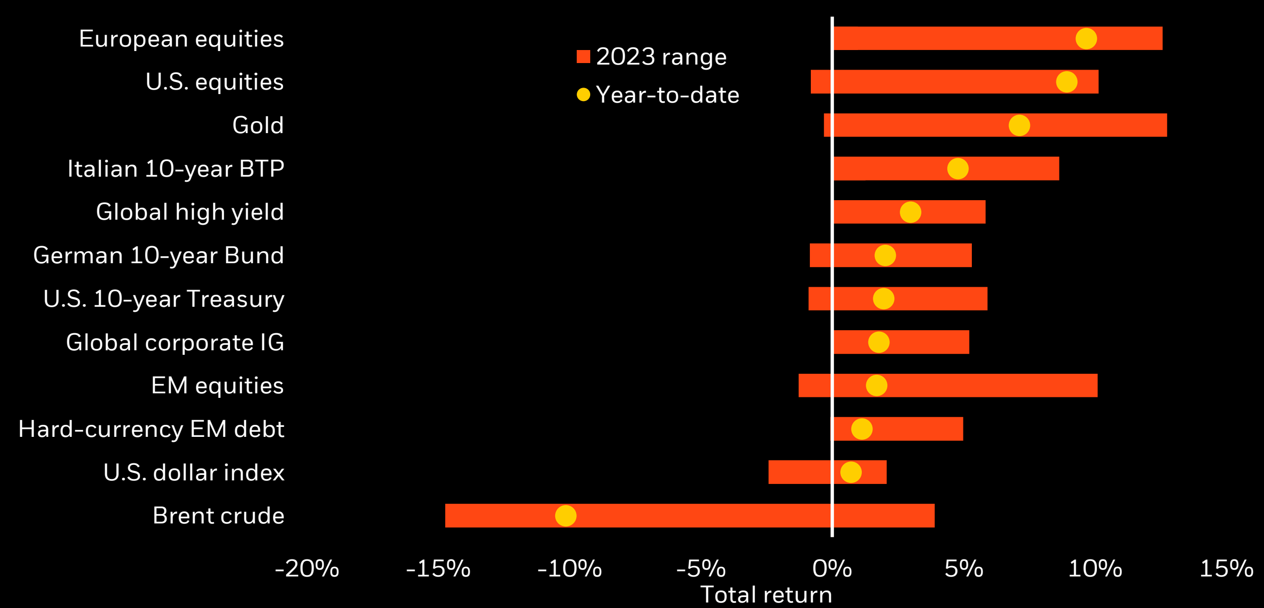
Bottom line: Markets are reassessing policy rate expectations as sticky inflation makes clear central banks won't cut them this year – or will keep hiking. We turn to high quality sources of income in the short term and stay cautious on risk assets.

Market backdrop

Major tech stocks surged further last week, leading U.S. stocks slightly higher – even as the U.S. potentially facing a technical default dominated market attention. Meanwhile, long-term Treasury yields climbed after data showed that April U.S. PCE inflation remained hot. A credit rating agency warning it could downgrade the top notch Treasuries rating if the U.S. defaults reinforces our view investors will demand more compensation for holding long-term bonds given higher policy rates.

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 25, 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

The latest economic data from Germany suggests that the economy shrank for the second quarter in a row – indicating a technical recession. Germany's GDP has now dropped below its pre-Covid level. See the chart.

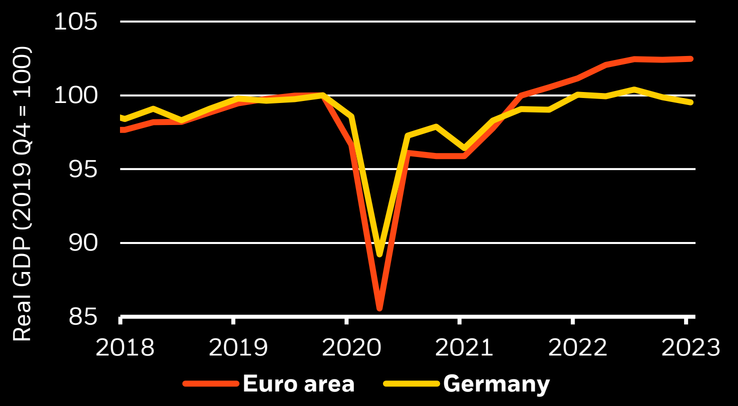
Energy prices surged following Russia's invasion of Ukraine last year, squeezing real incomes and dragging consumer spending down. German manufacturers suffered from both higher prices and shortages of crucial equipment.

The energy shock fading would usually indicate better times ahead. But we see the delayed impact from the European Central Bank's (ECB) rapid rate rises kicking in as the energy shock fades. And that's why we expect economic activity to contract across the euro area later this year. A contraction should help bring core inflation down from its current highs, but we still see inflation persisting above the ECB's 2% target in the coming quarters. That leaves no room for the ECB to consider cutting interest rates this year, in our view.

Explore our recent Macro take blog posts here.

Contracting activity

Euro area and Germany real GDP, 2018-2023



Source: BlackRock Investment Institute, Eurostat, with data from Haver Analytics, May 2023. Notes: The chart shows demand in the economy, measured by real GDP, for the euro area and Germany, rebased to Q4 of 2019.

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 31	China manufacturing PMI
June 1	Euro area inflation; U.S. manufacturing PMI
June 2	U.S. payrolls

We're watching key inflation and labor market data in developed markets this week. We see wage pressures from a tight labor market in the U.S. and euro area keeping core inflation above policy targets for some time. We expect some easing of labor market tightness as the lagged effect of rate hikes by major central banks starts to hit economic activity.

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	Neutral	Neutral	Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. 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 stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're 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	Neutral	—	We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, 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.
Equities	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.
Equities	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.
Equities	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
Equities	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.
Equities	**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.
Equities	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.
Equities	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.
Fixed Income	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.
Fixed Income	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
Fixed Income	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
Fixed Income	UK gilts	Neutral	We are neutral. We find gilt yields attractive as they have risen back near levels reached during 2022's budget turmoil. We prefer short-dated gilts for income.
Fixed Income	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
Fixed Income	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.
Fixed Income	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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