Weekly commentary

BlackRock.

March 6, 2023

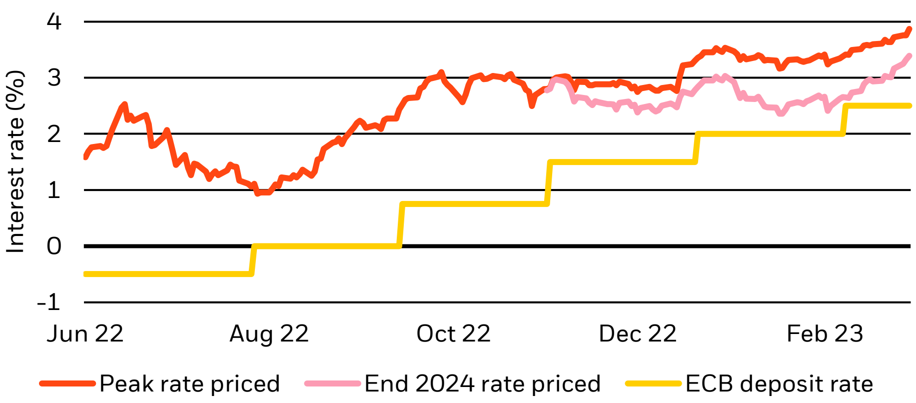
Europe: Sticky inflation favors income

- We think improving euro area activity signals more rate hikes to come. We like short-term government bonds, high-quality credit and selected equity sectors.
- Data last week showed still-high euro area inflation and strong U.S. manufacturing activity. So we see central banks keeping rates higher for longer.
- This week's U.S. jobs data will help gauge how tight the labor market remains, a key factor keeping core services inflation stubbornly high.

European stocks have outperformed this year as China's economy restarts and the energy shock proved less severe than expected. We don't see the outperformance lasting: The market's focus is shifting to sticky inflation due to firms upping wages to hire and retain staff. Good news on the economy means the European Central Bank (ECB) needs to hike rates more to cool inflation. We still expect a recession as higher rates kick in. We prefer short-term bonds for income.

Shifting expectations

Market pricing of peak and end-2024 ECB policy rate, 2022-2023



Source: BlackRock Investment Institute, with data from Refinitiv, March 2023. Notes: The orange line shows peak or terminal ECB policy rate expectations based on futures prices. The pink line shows expectations for the end of 2024, the yellow line shows the actual path of the ECB deposit rate.

Euro area stocks have outperformed U.S. peers by about 14% in local currency terms since the end of September, MSCI index data shows. That's partly because the economy has withstood the energy crunch even as the war in Ukraine drags on. Plus, export-centered sectors also look set to benefit from China's restart. Yet good news on growth now means the ECB has more work to do to cool inflation later, as we said for the U.S. We think that's bad news for Europe's risk assets. We see policy rates already on track to tip the economy into recession this year after growth stagnated at the end of 2022. Data last week showing core inflation rising and services activity improving may push the ECB to hike more. Market pricing now expects rates to peak around 3.9% (orange line in chart) versus about 3.2% in February, with fewer rate cuts seen in 2024 (pink line).

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Europe's cooling goods inflation and lower gas prices have driven a drop in overall inflation. We think elevated services inflation will prevent inflation from falling to the ECB's 2% target on its own – similar to the U.S. That's because wage inflation is bleeding into the services sector. The reason: European firms are raising pay to recruit new hires given a surge in workers jumping to the public sector. That labor marker tightness looks set to persist. Data last week confirmed euro area unemployment is near a record low. The ECB faces a stark trade-off between pushing up unemployment or living with persistent inflation. ECB officials seem determined to do "whatever it takes" to get inflation down to target, in our view, as that is their only objective. We expect the ECB to raise rates through midyear and not cut them until the second half of 2024.

We think this backdrop of higher rates and persistent inflation boosts the appeal of high-quality European credit and short-term government bonds. Yields have jumped from their ultra-low levels reached during a decade of negative interest rates. Strong corporate balance sheets limit the risk of credit defaults when recession hits, in our view. We're overweight both on a tactical horizon of six- to 12-months. We also turn to credit for income from a strategic horizon of five years and beyond.

We don't think European stocks are pricing in the economic pain we see ahead even as valuations look inexpensive relative to the past and regional peers. Stocks could also lose support if foreign investors' attention shifts, as it historically has. We're tactically underweight developed market (DM) stocks, including Europe. Within Europe, we favor the financial sector as rates rise. We also like the energy sector given the energy shortage, stronger balance sheets and better return on equity than in the past. We favor healthcare on its relatively steady cash flows in economic downturns and strong growth potential from long-term trends like aging populations. Plus, we like the consumer discretionary sector as European brands benefit from ramped up demand for luxury goods from China's restart. Our preferences underpin why we're neutral on Swiss stocks compared with our overall underweight in Europe. The financial, healthcare and consumer staple sectors dominate the index. We are strategically overweight DM stocks and expect earnings to recover once recessions end. We also see returns surpassing bond returns as yields rise due to investors demanding more compensation for risk amid high inflation and heavy debt loads.

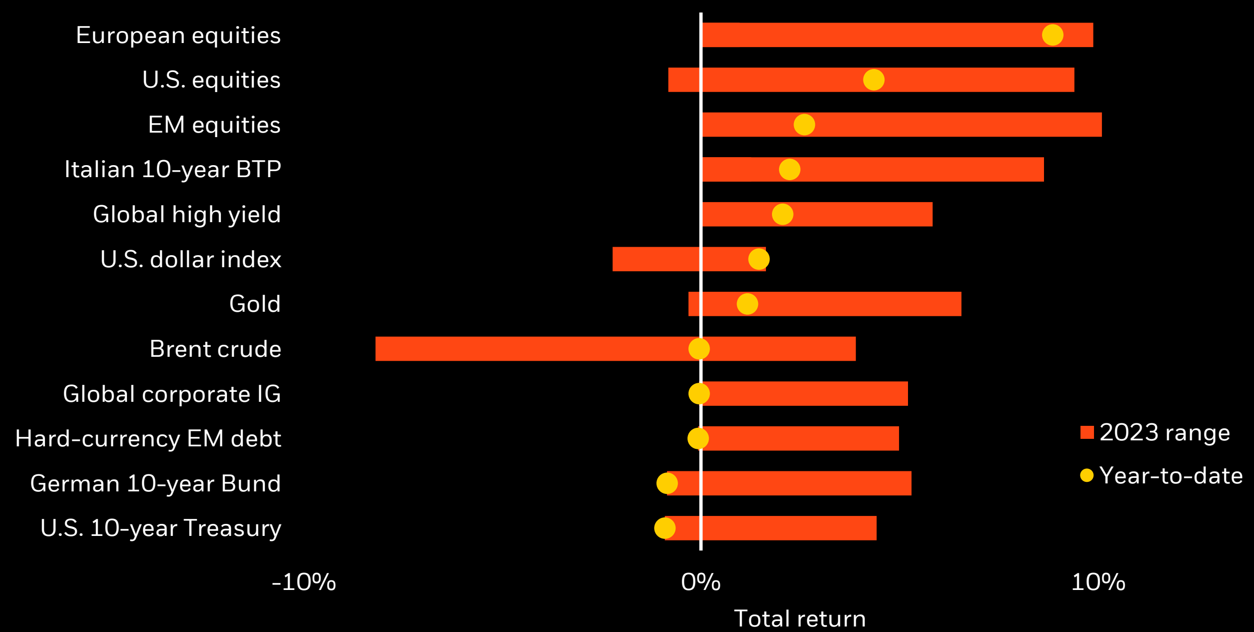
Bottom line: European risk assets have outperformed so far this year. But we think that trend will end as recent data pushes the ECB to raise rates and keep them higher for longer. We prefer income from credit and short-term government bonds. We're underweight European stocks but like the financial, energy, healthcare and consumer discretionary sectors.

Market backdrop

Global stocks steadied after giving up half of their January gains, while short-term U.S. Treasury yields hit 16-year highs near 5%. Data showed core euro area inflation hitting a record high, and both U.S. manufacturing and services activity holding up. We think the data signals that the ECB and Federal Reserve will hike interest rates higher and keep them there for longer to get inflation down. That's why we expect mild DM recessions and don't see central banks cutting rates this year.

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 March 2, 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

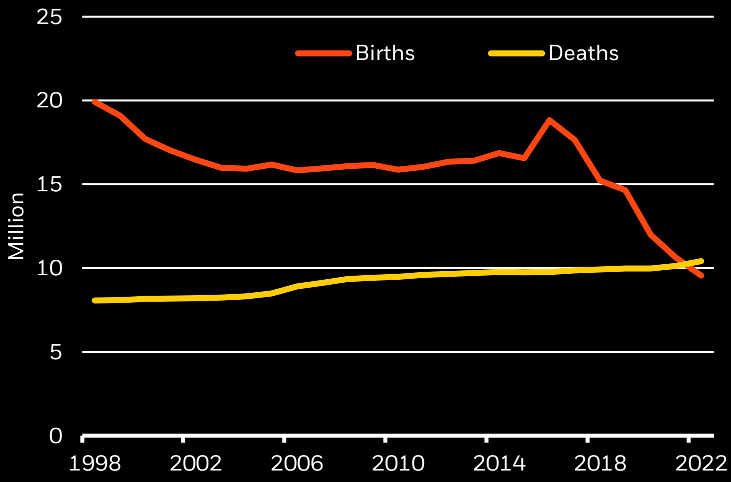
We think China will experience a growth spurt north of 6% this year – strong, but not all that strong given the economy is restarting. Working in the opposite direction is a big drop in demand for Chinese exports. We see two factors challenging China's ability to keep growing at more than 5% annually once the reopening has played out.

The first is a shrinking population. In 2022, China's population shrank for the first time since the Great Famine of 1959-1961. See the chart. And the country has suffered a tragic spike in Covid-related deaths since the most recent data, exacerbating the decline in population size. The government could well implement policies to increase the birth rate this year – but that won't be enough to reverse the decline, we think. The birth rate was falling rapidly even before Covid. We think China's population has likely peaked.

Second, heightened geopolitical risks, strategic competition with the U.S. and China's strict regulation of firms are likely to dampen productivity growth and make it difficult to boost long-term growth. Read more in our latest Macro take.

China's shrinking population

China deaths and births, 1998-2022



Sources: BlackRock Investment Institute, China National Bureau of Statistics, March 2023. Notes: The yellow line shows the number of deaths. The orange line shows the number of babies born.

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

March 7	China trade
March 9	China inflation
March 10	Bank of Japan policy decision; U.S. payrolls

We're watching U.S. payrolls this week to gauge how tight the U.S. labor market remains after the unemployment rate hit a five-decade low. Further labor market tightness could stoke persistently high core inflation and spur the Fed to keep rates higher for longer. We're also watching China's trade data to see how much pressure remains on exports.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, March 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, March 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.
Equities	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.
Equities	Europe	-1	We are underweight. The energy price shock and policy tightening raise stagflation risks.
Equities	UK	-1	We are underweight. We find valuations expensive after their strong relative performance versus other developed markets thanks to energy sector exposure.
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 short-term government bonds for income in this environment given the rise in yields and limited exposure to interest rate swings.
Fixed Income	Global inflation-linked bonds	+1	We are overweight. We see breakeven inflation rates underpricing the persistent inflation we expect.
Fixed Income	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.
Fixed Income	UK gilts	-1	We are underweight. Perceptions of fiscal credibility have not fully recovered. We prefer short-dated gilts for income.
Fixed Income	China govt bonds	Neutral	We are neutral. We find their yield levels less attractive than those on DM short-term government bonds.
Fixed Income	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.
Fixed Income	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.
Fixed Income	Global high yield	Neutral	We are neutral. We prefer up-in-quality credit exposures.
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	Neutral	We are neutral EM debt after its strong run. We see better opportunities for income in DMs.
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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