Weekly commentary

BlackRock

May 23, 2022

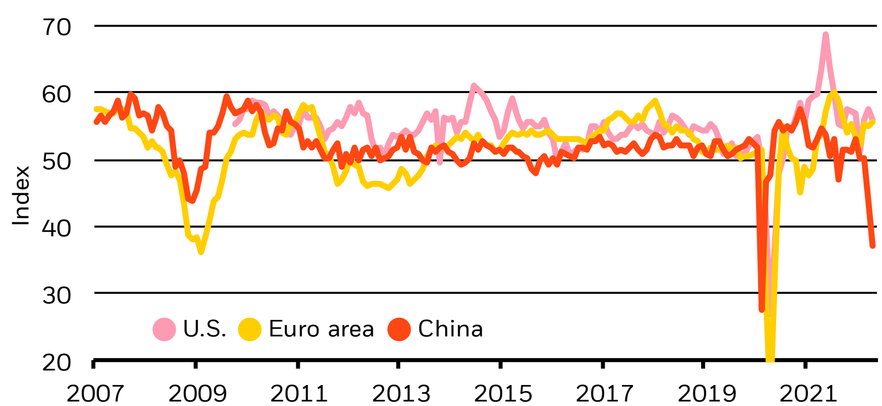
Turning neutral on DM equities

- We cut developed market (DM) equities to neutral on a risk of the Fed talking itself into overtightening policy and China adding to a weaker global outlook.
- Stocks plumbed new 2022 lows on fears steep rate rises will trigger a growth slowdown. We see a brighter picture, but this may not become clear for months.
- U.S. PCE inflation data this week are expected to show pressures are slowing. We think inflation will settle higher than pre-Covid levels.

The Federal Reserve signaled its focus is on taming inflation without flagging the big economic costs this will entail. As long as this is the case and markets believe it, we don't see the basis for a sustained rebound in risk assets. We think the Fed will consider the costs to growth at some point, especially if inflation cools, and expect a dovish pivot later this year. China's slowdown is a large shock that will be felt over time. We further trim risk and downgrade DM equities to neutral.

China slowdown to ripple across globe

Composite PMIs 2008-2022



Sources: BlackRock Investment Institute, S&P Global and Caixin, with data from Refinitiv Datastream, May 2022. Notes: The chart shows composite (manufacturing and services) Purchasing Managers' indexes (PMI). An index level above 50 indicates an improvement in economic activity, while an index level below 50 indicates a decline. S&P PMIs are used for U.S. and Euro area, Caixin for China.

The Fed stepped up its rhetoric last week by vowing to bring inflation down at any cost. We think reality will be more complex. First, supply-driven inflation implies the sharpest policy trade-off in decades: between choking off growth via sharply higher rates or living with supply-driven inflation. Second, this trade-off is even more stark amid a weaker global macro outlook. The hit to Chinese growth is starting to rival its 2020 shock and already surpasses the one from the global financial crisis. See the chart. We think this will reduce growth in major economies and nudge up DM inflation at a very inopportune time when higher inflation is already proving more persistent. We had already seen Europe at risk of recession, which prompted us to reduce risk a few weeks ago. As a result, we further downgrade DM equities to neutral from overweight.

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BlackRock **Investment** Institute

The Fed's hawkish pivot this year has been stunning, and pronouncements on reining in inflation have become regular fare. Chair Jerome Powell just last week said the Fed would keep hiking rates until inflation is "tamed" – a comment that dismisses any trade-off or the lagged effect of monetary policy on the economy. The Fed now appears to be constraining itself to the hawkish side of policy options with such language, just as talking about the jump in inflation being "transitory" last year boxed it in when inflation proved more persistent and forced a sharp pivot. We think the Fed could be forced into another sharp pivot later this year, which we expect rather than a recession. These Fed pivots are driving market volatility, in our view.

Market expectations are now calling for the Fed funds rate to zoom up to a peak of 3.1% over the next year, more than doubling since the start of the year. For the European Central Bank, market pricing reflects four hikes this year and getting to nearly 1.4% next year, well above our estimate of neutral and for an economy at real risk of stagflation this year. The equity selloff this year makes sense from this perspective – if you believe that the market's view of the Fed and ECB rate paths are right.

The growth reality will be more complex – both from the policy trade-off it faces amid a deteriorating macro backdrop, especially China's slowdown and Europe facing stagflation. That's why we expect a dovish pivot later in the year. We stick to our view of the Fed raising rates to around 2.5% by the end of this year – and then stopping to evaluate the effects. We still see the U.S. economy's momentum as strong – we expect growth of around 2.5% this year, slightly below consensus and far from recession. Equities may have short-term, technical rebounds. Yet until the Fed starts to pivot, we don't see a catalyst for a sustained rebound in risk assets.

The upshot? We further reduce portfolio risk after having trimmed it to a benchmark level a few weeks ago with the downgrade of European equities. We are now neutral DM equities, including U.S. stocks. But a dovish pivot by the Fed would spur us to consider leaning back into equities. Our change in view prompts us to keep an overweight to inflation-linked bonds from a whole-portfolio perspective. We prefer short-term government bonds for carry, and see scope for long-term yields to rise further as investors demand greater term premium for the risk of holding such debt in this inflationary environment. Overall we remain underweight U.S. Treasuries.

Market backdrop

Stocks plumbed new 2022 lows and bond yields edged down last week on concerns that higher rates are causing a growth slowdown. Earnings updates from large U.S. retailers underscored inflation is pinching demand – and eroding profit margins through higher costs. We see this year's equity pullback in line with the hawkish repricing of the policy rate path. We believe the market will ultimately ease its expectations for policy tightening – but this won't be clear for months.

Assets in review

Selected asset performance, 2022 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 19, 2022. Notes: The two ends of the bars show the lowest and highest returns at any point this year to date, 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.

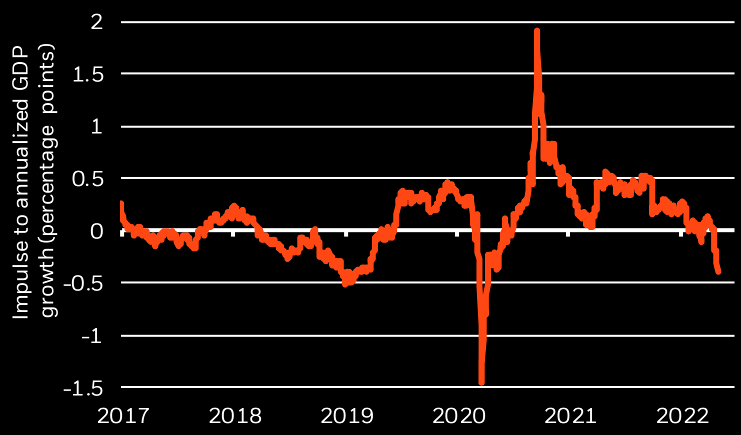
Macro insights

U.S. financial conditions have tightened a lot in the last six months – in other words, financing is becoming more costly for individuals and companies. That tightening can be seen across multiple market gauges captured in our indicator: higher bond yields, falling equity prices and soaring mortgage rates. Tighter financial conditions typically slow economic growth. We think they could knock around 40 basis points off GDP over coming months. See the chart.

Why is this happening? The Fed is raising policy rates to achieve precisely that. The goal is to bring down inflation by curbing what it considers to be excessive demand. It's true that the economy doesn't need ultra-loose financial conditions like it did at the start of the pandemic: the economic restart is self-sustaining. But there's a risk that they become too tight and slow the economy too much. We think pushing policy rates past neutral would be too much. Especially since it's not only tighter financial conditions that could slow growth: the slowdown in China could ripple out and hit the U.S. So the Fed is treading a tricky path, in our view. See our macro insights hub.

Tighter conditions

BlackRock U.S. financial conditions indicator, 2017-2022



Sources: BlackRock Investment Institute and Bloomberg, May 2022. Notes: The chart shows the six-month change in our financial conditions indicator (FCI). This gauges how much financial conditions are adding to or dragging on annualized GDP growth in percentage points. The FCI inputs include policy rates, bond yields, corporate bond spreads, equity market valuations and exchange rates.

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. If they hike interest rates too much, they risk triggering a recession. If they tighten not enough, the risk becomes runaway inflation. It's tough to see a perfect outcome.
- The Fed has made clear it is ready to dampen growth. It has projected a large and rapid increase in rates over the next two years, and raised rates by 0.5% in May - the largest increase since 2000. We see the Fed delivering on its projected rate path this year but then pausing to evaluate the effects on growth.
- Normalization means that central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. The risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- The Bank of England warned of the poisonous combination of recession and high inflation as it raised interest rates to their highest level since 2009.
- The European Central Bank has also struck a hawkish tone and looks poised to raise rates in July, but we expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation.
- **Investment implication**: We are neutral DM equities after having further trimmed risk.

2 Cutting through confusion

- We had thought the unique mix of events – the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks – could cause markets and policymakers to misread the current surge in inflation.
- We saw the confusion play out with the hawkish repricing in markets this year – and central banks have sometimes been inconsistent in their messages and economic projections, in our view.
- The Russia-Ukraine conflict has aggravated inflation pressures and has put central banks in a bind. Trying to contain inflation will be more costly to growth and employment, and they can't cushion the growth shock.
- We see a worsening macro outlook because of the Fed's determination to slow growth, the commodities price shock and the spillovers from a growth slowdown in China.
- **Investment implication:** We remain underweight U.S. Treasuries and overweight inflation-linked bonds.

3 Navigating net zero

- Climate risk is investment risk, and the narrowing window for governments to reach net-zero goals means that investors need to start adapting their portfolios today. The net-zero journey is not just a 2050 story; it's a now story.
- The West's decision to reduce reliance on Russian energy will encourage fossil fuel producers elsewhere to increase output, but we don't expect an overall increase in global supply and demand. We see the drive for greater energy security accelerating the transition in the medium term, especially in Europe.
- The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view. Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor sectors with clear transition plans. Over a strategic horizon, we like sectors that stand to benefit more from the transition, such as tech and healthcare, because of their relatively low carbon emissions.
- **Investment implication**: We favor equity sectors better positioned for the green transition.

Week ahead

May 24	Global May flash PMIs	**May 27**	U.S. PCE inflation and spending; Japan CPI
May 25	U.S. durable goods; Germany GDP		

This week's U.S. PCE report is expected to show monthly U.S. inflationary pressures softening as spending shifts back to services and away from goods. Early May global PMI data could give an early read on spillovers from China's slowdown and the knock-on impact on supply chains. We expect China's deteriorating economic outlook to be a drag on global growth – and we think consensus forecasts for China's 2022 GDP growth are likely to get revised down.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2022

Underweight | **Neutral** | **Overweight** | ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	Neutral	We stay overweight equities in our strategic views, yet are trimming our overall tilt as the relative appeal versus bonds has diminished. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we downgrade DM equities to neutral due to a higher risk of central banks overtightening policy and a deteriorating growth backdrop in China and Europe.
Credit	-1	Neutral	We are underweight credit on a strategic basis against a backdrop of rising interest rates. We prefer to take risk in equities instead. Tactically, we had upgraded credit to neutral as the dramatic selloff this year restored value in areas such as investment grade. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk, in our view.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds, with a preference for shorter-dated maturities over long-dated bonds. We see yields broadly climbing higher. We stay firmly underweight the long-end as we see investors demanding higher compensation for holding government bonds amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we also underweight government bonds as we see the direction of travel for long-term yields as higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers in the higher inflation regime.
Private markets	Neutral	—	We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and 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 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	Neutral	We downgrade DM stocks to neutral due to uncertainty over policy amid a worsening macro picture. Their appeal relative to bonds has also diminished. The risk has risen that central banks slam the policy brakes as they focus solely on inflation without fully acknowledging the high costs to growth and jobs.
United States	Neutral	We cut U.S. equities to neutral. The Fed's hawkish pivot has raised the risk that markets see rates staying in restrictive territory. The year-to-date selloff partly reflects this, yet we see no clear catalyst for a rebound.
Europe	Neutral	We cut European equities to neutral as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued.
Japan	Neutral	We cut Japan stocks to neutral as part of a broader push to take more caution across DM equities.
China	Neutral	We recently downgraded Chinese equities to neutral on a worsening macro outlook. China's ties to Russia also have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities given challenged restart dynamics, high inflation pressures and tight policies.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's deteriorating macro outlook is a worry, and policymakers have yet to fully deliver on promises of easing.
U.S. Treasuries	-1	We underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
Treasury Inflation-Protected Securities	+1	We overweight U.S. TIPS as we see inflation as persistent and settling above pre-Covid levels. We prefer TIPS as diversifiers in the inflationary backdrop.
European government bonds	Neutral	We are neutral European government bonds. Market pricing of euro area rate hikes is too hawkish, we think, given the energy shock's hit to growth.
UK gilts	Neutral	We are neutral UK Gilts. We see market expectations of rate hikes as overdone amid constrained supply and weakening growth.
China government bonds	Neutral	We are neutral Chinese government bonds. Policymakers have been slow to loosen policy to offset the slowdown, and yields fell below U.S. Treasuries.
Global investment grade	Neutral	We are neutral investment grade credit as this year's selloff has made valuations more attractive. Coupon income is the highest in about a decade.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive.
Emerging market – hard currency	Neutral	We are neutral hard-currency EM debt. We expect it to gain support from higher commodities prices but remain vulnerable to rising U.S. yields.
Emerging market – local currency	+1	We are modestly overweight local-currency EM debt on attractive valuations and potential income. Higher yields already reflect EM monetary policy tightening, in our view, and offer compensation for interest rate risk.
Asia fixed income	Neutral	We are neutral Asia fixed income. A worsening macro outlook and geopolitical concern about China's Russia ties make Chinese assets riskier, in our view. Outside China, we like Asian sovereigns and credit for income.

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