Weekly commentary

May 31, 2022

BlackRock

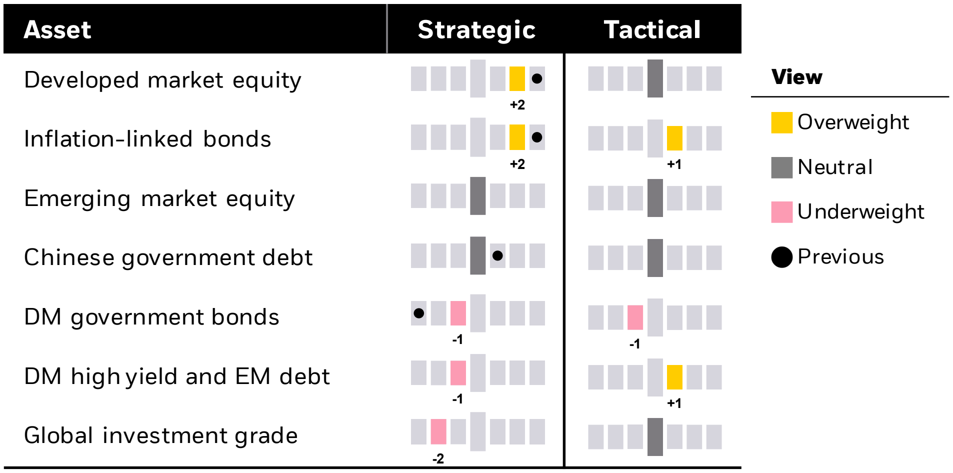
Sticking with our strategic views

- We still prefer equities over fixed income on a strategic horizon, but we moderate our stance after this year's big market moves.
- Stocks bounced back on hopes the Federal Reserve can soon pause rate hikes. But we don't expect a sustained rebound until the Fed takes a clear dovish turn.
- Euro area inflation data will be in focus. The European Central Bank president made clear rate hikes will start in July. We see market pricing as too aggressive.

On a strategic horizon of five years and longer, our asset views are still positioned for an inflationary environment. We see inflation easing yet settling above pre-Covid levels: central banks will choose to live with some supply-driven inflation rather than destroy growth and jobs to fight it. That's why we favor equities over bonds. Yet we are cautious near term. The market pricing in an inflation-fighting Fed remains a serious risk. So we don't see a case for a sustained equity rebound.

Equities over bonds for the long term

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



Source: BlackRock Investment Institute. Note: The chart shows our broad strategic (10-year) and tactical investment views. 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.

The key change in our quarterly strategic update is to trim tilts across asset classes given the large market moves since our last update in February. The relative appeal of developed market (DM) equities over government bonds has narrowed as yields have surged. We have reduced our underweight to government bonds and trimmed our overweight to DM equities. Yet DM equities and inflation-linked bonds remain our largest strategic overweights. We see the path of short-term rates – a key input in our return expectations – repricing lower as the policy trade-off on dealing with supply-driven inflation becomes clearer, and we see growth holding up as a result. Yet we have less conviction on both fronts in the near-term given the risk that the market still sees the Fed going too far in pushing up rates. This caution is reflected in our tactical stance being broadly neutral across asset classes relative to our strategic views. See the summary above.


Jean Boivin
Head – BlackRock Investment Institute


Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute


Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute


Natalie Gill
Portfolio Strategist – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock Investment Institute

We stick with our conviction that the path of U.S. short-term rates will be less than what the market is pricing in now. That underpins our strategic views and is why we prefer equities over government bonds. Yet we have less conviction in that view over the next 6-12 months – our tactical horizon. That is why we gradually trimmed tactical risk all year and downgraded DM equities to neutral this month. We are looking for a decisive dovish pivot from the Fed to flip back overweight. Until then, we think risk assets may be disappointed: it may take some months for the conditions allowing a policy pivot to take shape. We see inflation easing as supply disruptions unwind, allowing such a pivot – even if inflation remains higher than pre-Covid levels. Central banks will choose to live with some inflation rather than destroy growth and employment in a bid to fight supply-driven inflation, in our view. In other words, they will likely pause after hurrying back to around neutral on policy rates.

We have seen historic market moves in the first months of the year already in the direction of our strategic views, especially in nominal government and inflation-linked bonds – and trim our tilts as a result. We had maintained a high-conviction underweight to DM nominal government bonds since March 2020. Since then, the Bloomberg U.S. Treasury index is down 18%, according to Refinitiv data. The outlook for long-term bonds remains challenged. We see further room for long-term yields to rise as investors demand a term premium for holding longer maturities in coming years due to high debt burdens and inflation risks. The jump in short-term yields and our expectation that the policy rate path will reprice lower mean we like shorter maturities over longer ones. This yield curve view moderates our overall underweight on government bonds. We prefer private credit over public credit on a strategic horizon due to our higher expected returns on a risk-adjusted basis. And not all strategic and tactical views are different. We still like inflation-linked bonds on both strategic and tactical horizons.

Near-term risks appear skewed to the downside for growth and risk assets: central banks talking tough on inflation, an ongoing commodity price shock and China's restrictive Covid lockdowns adding to a weaker macro outlook. We believe the consequences of these risks will be most deeply felt by markets over a tactical horizon – and have reduced portfolio risk in recent weeks. But we don't think they matter yet for a strategic horizon of five years and longer.

Bottom line: We maintain our view favoring DM equities over fixed income on a strategic horizon. This difficult market and macro environment has brought into sharp focus the importance of taking time horizons into account when arriving at investment views.

Market backdrop

U.S. equities bounced back from their 2022 lows, while U.S. Treasury yields dipped. The Fed's May meeting minutes also confirmed it was considering a two-phase approach to policy tightening, getting to neutral – a level that neither stimulates nor restricts the economy – in phase one and then pausing to assess the impact. That opens the door for a dovish pivot, but we don't think a sustained risk asset rally is likely until such a pivot becomes clearer.

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 26, 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.

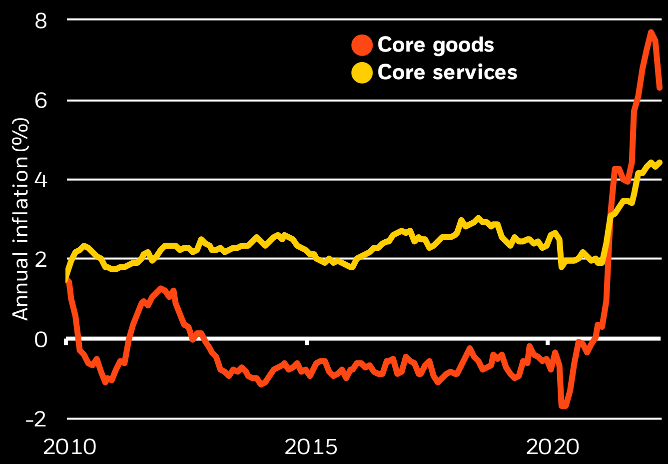
Macro insights

U.S. consumers are spending more, last week's U.S. personal consumption data show. But goods spending is not rising as quickly as it was last year. That's helping ease pressure on goods prices, which have been growing at the fastest rate in nearly 40 years. See the orange line on the chart. Services inflation is still somewhat elevated (yellow line).

The split between goods and services spending has been key to recent inflation dynamics. Early in the pandemic, the forced closure of many services, as well as stay-at-home mandates, meant people spent more on goods. But the shutdowns also made it more difficult for companies to produce those goods. That created a huge demand/supply imbalance, pushing up goods prices especially. Now that the economy is reopening, spending should start normalizing as people go out to places like restaurants and theaters again. Supply is coming back, too: more people are in service sector jobs, and supply chains are mending. This normalization of both supply and demand will help lower overall inflation – though not all the way back to pre-Covid levels, we think. See our macro insights hub.

Spending mix key to inflation

U.S. core goods and services PCE inflation, 2000-2022



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, May 2022. Notes: The orange and yellow lines show core goods and core services PCE inflation respectively, measured by the year-on-year percent change in price.

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. Hiking interest rates too much risks triggering a recession, while not tightening enough risks causing unanchored inflation expectations. 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 unanchored inflation expectations has increased as inflation becomes more persistent.
- The Bank of England warned of the poisonous combination of recession and high inflation as it has 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 jobs. Central banks can't cushion the growth shock.
- We see a worsening macro outlook because of the Fed's hawkish pivot, 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 31	Euro area inflation; U.S. consumer confidence; China manufacturing PMI
June 1	U.S. ISM manufacturing PMI; euro area unemployment
June 3	U.S. payrolls report

Euro area inflation data will be in focus this week after ECB President Lagarde indicated rate hikes will kick off in July. We think the market's pricing of the ECB rate path is too aggressive and see the ECB pausing its hiking cycle amid materially weaker growth. The U.S. payrolls report provides an update on the interplay of jobs and wages the Fed is closely watching.

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 are overweight equities in our strategic views, yet trimmed our overall tilt as the relative appeal versus bonds 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 are neutral DM equities 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 are neutral DM stocks 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 are neutral U.S. equities. 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 are neutral European equities 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 are neutral Japan stocks as part of a broader push to take more caution across DM equities.
China	Neutral	We are neutral Chinese equities 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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee