Weekly commentary

June 21, 2022

BlackRock

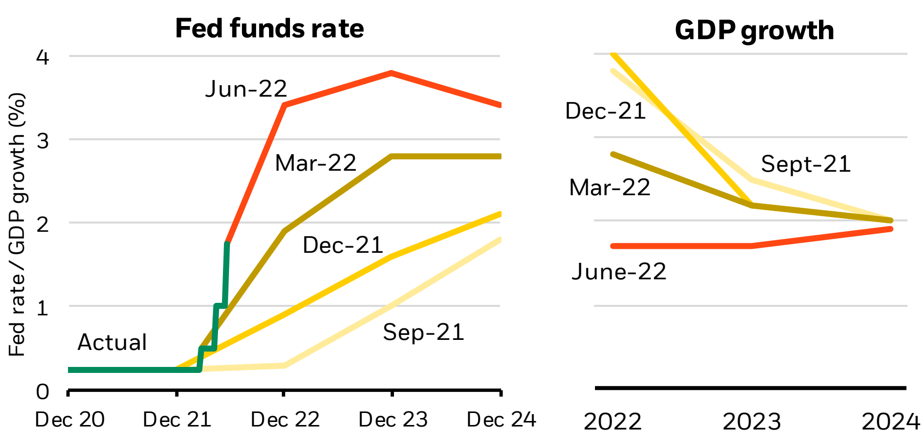
Central bank blitz to hit growth

- We see the Fed on a path to raise rates far enough this year to hurt growth. The U.S. activity restart from the pandemic could grind to a halt in coming quarters.
- The Fed lifted rates by 0.75% in a rush to normalize policy, its biggest hike since 1994. Other central banks joined, sending shockwaves through markets.
- This week's U.S. and European PMI updates will give an early read on June growth momentum and help gauge the easing of supply chain disruptions.

A flurry of central bank moves last week has revealed many are ignoring the crushing effect this will have on growth. This dynamic raises serious growth risks, and we now see the U.S. restart of economic activity stalling over the coming quarters. The focus is on the Fed – and we think it will ultimately change course but not before causing growth to stall. This raises the specter of growth weakness but still persistent inflation. We don't see this as an environment for buying the dip.

Fed projections

Fed funds and GDP growth projections by meeting



Sources: BlackRock Investment Institute and Federal Reserve, June 2022. Notes: The charts show the progression of the Fed's median projection for the Fed funds rate and GDP growth in its quarterly Summary of Economic Projections.

The Fed's updated "dot plot" of the Fed funds projection shows it's ready to push rates to nearly 4% by next year (red line, left chart). This takes rates well beyond neutral of around 2.5% – the level that neither stimulates nor decreases economic activity. Yet the Fed continues to forecast trend-like growth (red line, right chart). Financial conditions are already quickly tightening. And with growth slowing elsewhere and higher energy prices, we expect a worsening macro environment for the rest of the year and into 2023. The Fed isn't looking for a recession, even though in our view one would be needed if it wanted to drive inflation back down to 2%. So we expect the Fed to change course once it becomes clear growth has stalled.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

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The Fed seems dead set on raising rates this year to levels that, in our view, would clearly slow the economy. It seems to be responding to the "politics" of current high inflation. But the Fed isn't actually looking to slow the economy. Fed Chair Jerome Powell said the central bank is not trying to induce a recession. This reflects the Fed's lack of acknowledgment of the policy trade-off. Current high core inflation rates reflect an imbalance of demand and supply broadly across the economy. It isn't due to overheating demand but unusually low production capacity in an incomplete restart following the pandemic.

In fact, the Fed is facing an acute trade-off: either slam down activity or live with persistent inflation while production capacity recovers. The Fed hasn't acknowledged this. It assumes that a rapid return of supply capacity will help resolve high inflation – so any upside surprise to inflation will push it toward tighter policy, and a downside surprise on inflation won't necessarily slow it down. If the Fed jacks up rates and then changes course as we expect, it still raises the risk of zero or negative growth and persistent inflation. When the macro environment is shaped by production constraints, the Fed can't avoid volatility. It can only trade inflation volatility for output volatility – a big theme at our 2022 Midyear Forum last week. We may be set for both, posing a further drag to risk assets.

How does the inflation/growth trade-off play out elsewhere? We think the European Central Bank (ECB) will be forced to confront reality sooner because the euro area will feel economic pain sooner. The ECB's planned policy normalization underappreciates the risk of the energy crisis pushing the euro area into recession. The ECB's troubles are seen in the peripheral bond volatility that sparked an emergency meeting last week to help steady financial conditions across the euro area. That comes as the Swiss central bank and the Bank of England (BOE) also raised rates last week, with the BOE warning of recession risks. The BOE is closer to acknowledging the policy trade-off and could decide to go slow on further rate hikes. The Bank of Japan bucked the trend, keeping its ultra-accommodative stance, largely because inflation remains low and Japan did not have harsh lockdowns driving the inflation volatility in other major economies.

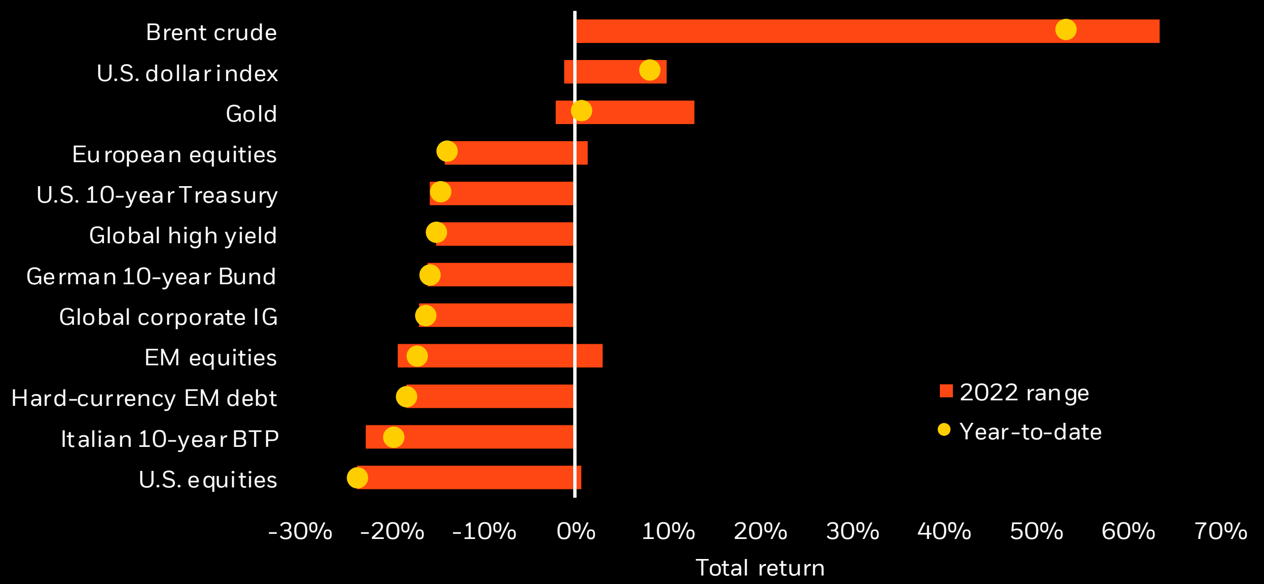
What does this all mean for investments? We already reduced portfolio risk twice this year on growing concerns over the effect of the energy crunch on growth and central banks overtightening. This is why we don't see the risk asset retreat as a reason to buy the dip – and expect more volatility ahead.

Market backdrop

The S&P 500 slid into bear market territory after the Fed lifted rates by the most in three decades. The Fed said it could push rates to 3.4% this year – a level that would hurt activity and could bring the restart to a halt, in our view. Other hawkish central bank moves followed. The Swiss National Bank unexpectedly hiked rates for the first time in 15 years. We think central banks' failure to acknowledge policy trade-offs amid the politics of high inflation raises serious growth risks.

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 June 17, 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.

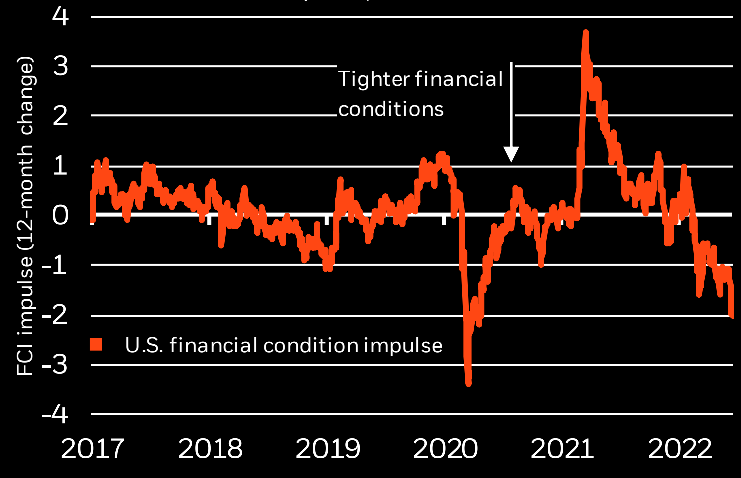
Macro insights

U.S. financial conditions have tightened a lot since the start of the year – in other words, financing is becoming more costly for individuals and companies. Since then, the pace of tightening has stepped up another gear. See the chart.

What's driving that? The Fed flagged its intent to go even harder on inflation by delivering a 0.75-basis-point rate hike last week, indicating more could come and projecting a higher end point for the hiking cycle – high enough to restrict economic activity. Markets have responded and financial conditions have tightened by a further 100 basis points since the start of June – and could tighten even more. We think that could knock around 1 percentage point off GDP in coming months, on top of the 0.4 percentage point hit we estimated for the tightening of financial conditions prior to June. Add that tightening to other growth drags in the U.S. – the potential spillover of weak growth in Europe and China, plus the domestic hit from higher energy prices – and the post-pandemic restart could well come to a standstill, as we discuss in this week's main commentary.

Financing conditions tightening fast

U.S. financial condition impulse, 2017-2022



Sources: BlackRock Investment Institute and Bloomberg, June 2022 Note: The chart shows the impulse to GDP growth from financial conditions, measured by the 12-month change in the Bloomberg U.S. financial conditions index. A negative number implies that financial conditions are dragging on growth.

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, raising rates by 0.75% in June in the largest increase since 1994. We ultimately think reality will come knocking and a stall in the restart will make the Fed reverse course.
- 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 further to 1.25% in June. This may indicate the start of a dovish pivot, in our view.
- The European Central Bank (ECB) announced plans to end asset purchases and implement a rapid series of rate hikes in an effort to stabilize peripheral bond yields. We think the ECB and markets underappreciate the risk of the energy crunch pushing the euro area into recession. We expect the ECB to accept this at some point and rethink its rate path.
- We believe the eventual sum total of rate hikes will be historically low given the level of inflation but brace for volatility in the short run.
- **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, production-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 persistently high inflation, 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

June 22	Euro area consumer confidence; UK CPI
June 23	U.S., euro area, UK and Japan flash PMI data; Japan CPI
June 24	UK retail sales; Germany Ifo survey; Brazil CPI

Services and manufacturing data in the U.S. and Europe will give an early read on growth momentum in June and help gauge the ongoing easing of supply chain disruptions. We think the risks to growth are escalating as many central banks steadfastly hike rates without fully acknowledging the high costs. UK inflation is likely to remain high in data out this week, fueling calls for a continued hawkish response from the Bank of England.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, June 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, June 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, and we are not looking to chase the rally in the energy sector as transition to net zero unfolds.
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.

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