Weekly commentary

June 27, 2022

BlackRock.

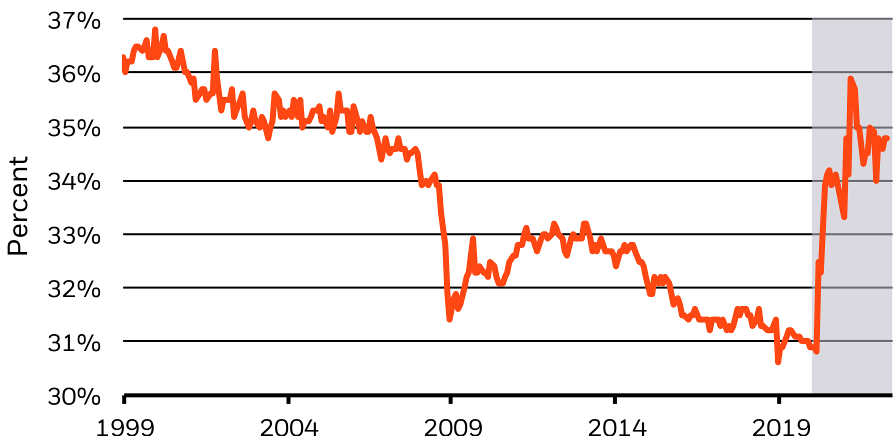
Outlook Forum debates new regime

- Growth concerns, inflation and volatility fueled the debate at our Outlook Forum over why we're entering a new macro and market regime and what that means.
- Poor activity data reinforced slowdown fears, resulting in falling yields and rising stocks last week. Persistent UK inflation caused worries of overtightening.
- This week's U.S. PCE inflation update may show if inflation pressures are easing. Euro area inflation data will likely reinforce the ECB's rate hike plans.

Global growth and inflation concerns are keeping investors up at night. This backdrop made for a spirited gathering at our June 14-15, 2022 Outlook Forum, a semiannual meeting we host for BlackRock's portfolio managers and executives. We made the case we're entering a new macro and market regime, and debated the implications at our first in-person Forum since the pandemic broke out in early 2020. Watch for updated investment views in our 2022 midyear outlook on July 11.

A historic shift

U.S. nominal goods share of consumer spending



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, June 2022.
Notes: The chart shows the U.S. goods share of nominal personal consumer expenditure from 1999 through 2022.

Many forum discussions centered on the production constraints driving today's inflation. The pandemic sparked a massive shift in consumer spending to goods and away from services. See the gray shaded area in the chart. This reallocation occurred as lockdowns limited production and movement – and led to a sectoral re-allocation of resources. The restart of economic activity unleashed pent-up demand for services, creating an ostensibly tight labor market. The war in Ukraine added an additional commodities price shock. These factors pushed up inflation to 40-year highs. Almost all Forum participants said average U.S. inflation would settle above the Federal Reserve's target of 2% over the next five years. That was a marked change from our November Outlook Forum, when only half forecast this. Participants were divided on how companies will adapt to this new environment – and whether they can maintain historically high margins amid rising input costs and the need to diversify supply chains in a more fragmented world.

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Concerns over a global growth slowdown weighed on participants as a stampede of central banks raised rates in an effort to rein in inflation – all in the week the Forum took place. Half of participants saw the restart stalling in the next two years, leading to a short and shallow global recession, up significantly from November 2021. Waning U.S. growth was in sharp focus as the risk of the Fed overtightening increases. The flurry of central bank rate hikes has shown many are ignoring the crushing effect this will have on growth, in our view, and we now see the U.S. restart of economic activity stalling.

A quickly changing world complicates matters. The war in Ukraine has exacerbated high inflation caused by the restart's supply disruptions - and sparked sharply higher commodity prices. Commodity prices are likely to stay elevated, Forum speakers said. Why? Lower production capacity after years of underinvestment as well as ballooning demand for industrial metals needed for the transition to net-zero carbon emission by 2050. The outperformance of traditional energy assets this year does not mean the transition is reversing, speakers said. It reflects higher expected earnings for companies replacing Russian energy supply. Energy use in coming decades will look very different, we believe, and lower carbon fossil fuels have a large role to play in enabling the transformation.

Geopolitical fragmentation is another tenet of the new regime, and the Ukraine war has accelerated this. The Forum focused on how many emerging market (EM) countries now try to find a middle ground between the U.S. and China or try to play one against the other. EM isn't what it used to be, anyway. The name itself is a misnomer as it hides an incredibly diverse set of countries. The old approach of chasing growth and cheap assets in EMs is outdated, Forum participants argued. It's now about quality investments, income potential and seeking out beneficiaries of "friend-shoring." Another change: EM dependence on China is declining, buffering some of the effects of China's lockdowns to prevent the spread of Covid-19.

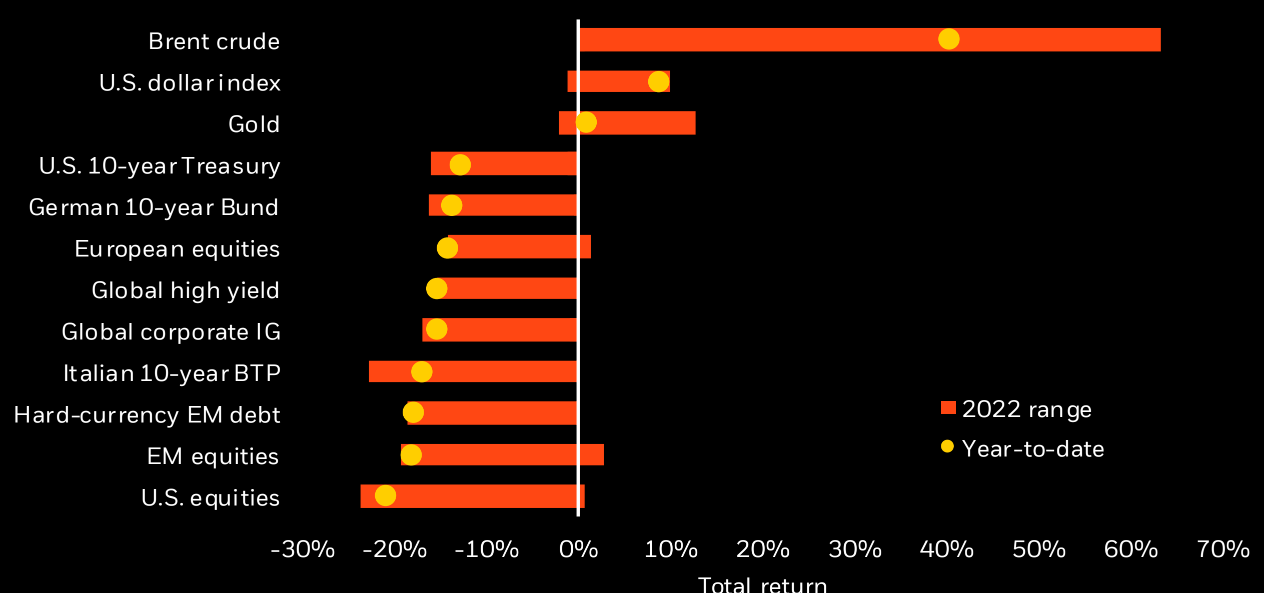
So how should investors adjust to all this? Ignore macro peril at your own risk. Most attendees said they expect to see short cycles, more macro volatility and volatile markets. They stressed the need to be make quicker portfolio shifts amid shrinking investment horizons and prioritize liquidity, too. Participants also questioned the classic portfolio construction setup of 60% stocks and 40% bonds. A 40-30-30 split – comprising traditional fixed income, public equities and private assets – is perhaps more apt in the new regime. Simply betting on mean reversion, or buying the dip won't work anymore, many agreed.

Market backdrop

Poor global PMI data reinforced slowdown fears, capping the rise in yields and triggering a rebound in stocks from 2022 lows. UK inflation hit a four-decade high of 9.1%, bolstering pressure on the Bank of England (BOE) to respond aggressively with further tightening. Many developed market (DM) central banks have moved ahead with rapid rate hikes without acknowledging how they could hurt economic activity. Failing to recognize policy trade-offs boosts risks to growth, we think.

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 24, 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

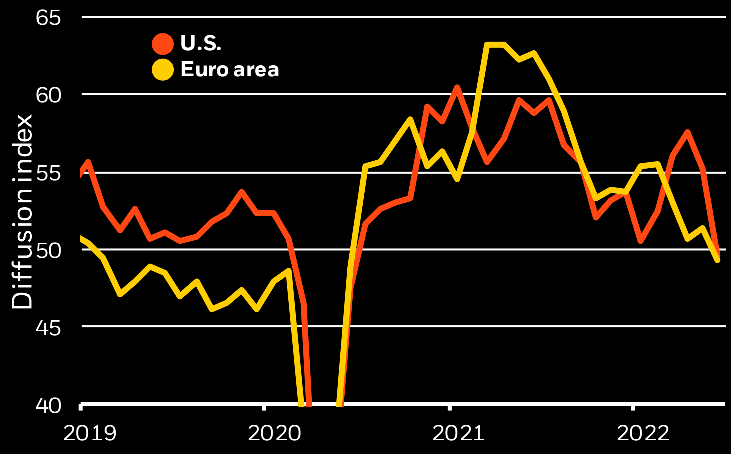
Manufacturers have slowed production substantially in both the U.S. and the euro area, according to survey data released last week – see the chart. Why? First, they have a build-up of existing stock that they haven't yet been able to sell. And second, there are fears about how strong demand for goods will be in coming months.

This reflects a broader slowdown happening across both economies: services growth is slowing, too. Several factors are behind the deteriorating outlook. Europe is feeling the energy shock exacerbated by the war in Ukraine more acutely. High energy prices are eating away at disposable income and consumer confidence is falling. That could spill over to the U.S., while slowing growth in China could ripple out to both. Another factor for the U.S. is the rapidly rising cost of finance – due to the Fed's decision to go hard on inflation. That typically weakens economic growth.

One positive sign for manufacturers? Supplier delivery times have shortened, potentially indicating pandemic-related production constraints are resolving. The risk? It's actually another sign of falling demand, rather than easing supply.

Manufacturers slow production

U.S. and euro area manufacturing output PMI, 2019-2022



Sources: BlackRock Investment Institute, Markit, with data from Haver Analytics, June 2022. Note: The chart shows the PMI surveys of manufacturing output for the U.S. and euro area. The survey is expressed as the balance of firms reporting an increase in output on the month minus those reporting a decrease, so a reading of over 50 implies that overall output increased in the month.

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 change 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 28	U.S. consumer confidence	**July 1**	Euro area inflation; U.S. ISM manufacturing PMI
June 30	China PMI; U.S. consumer spending and PCE inflation		

Inflation and survey data will be top of mind this week. In the U.S., an update on the Fed's preferred PCE inflation measure will shape its view of whether inflationary pressures are starting to subside amid a possible softening in activity surveys. Euro area inflation data will likely bolster the ECB's resolve to tighten policy in July. While we see the ECB raising rates materially in coming meetings, the burden of the energy shock hitting Europe will ultimately force it to rethink its hiking cycle.

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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