Weekly commentary

June 5, 2023

BlackRock

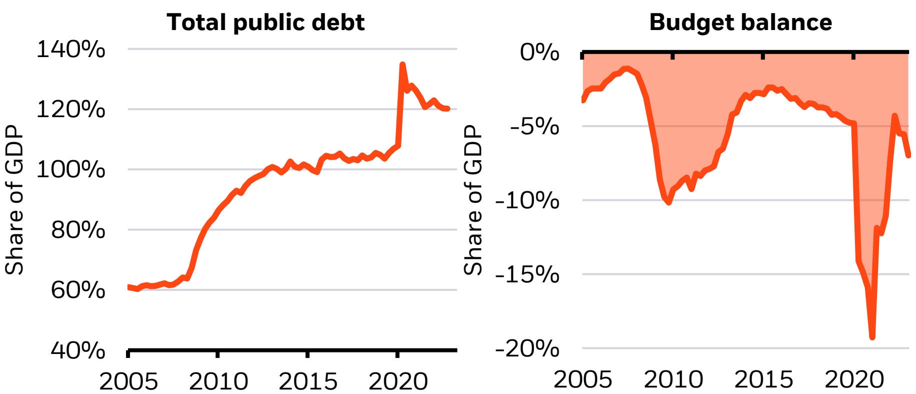
Macro outlook retakes spotlight

- We see the market's focus returning to higher-for-longer rates and sticky inflation after a U.S. debt ceiling deal. We prefer an up-in-quality portfolio.
- U.S. stocks hit 2023 highs after the debt ceiling deal. Yields rose amid the specter of rate hikes after Friday's payroll report showed a jump in new jobs.
- China macro data is in focus this week. We trim our growth view slightly as the economic restart loses steam and policy reactions remain uncertain.

Last week's U.S. debt ceiling deal removes near-term uncertainty and thrusts the market's focus back to the macro picture: sticky inflation due to tight labor markets. We see rates staying higher for longer as a result. We keep a quality tilt in portfolios and prefer income for now. Over time, we could see the attention shifting to the large U.S. debt load – and investors demanding more compensation for holding long-term government bonds.

Debt dilemma

U.S. total public debt and budget balance, 2005-2023



Source: BlackRock Investment Institute with data from Federal Reserve Bank of St. Louis, Bureau of the Fiscal Service and Refinitiv Datastream, June 2023. Notes: The left chart shows total public debt and the right chart shows the U.S. federal government budget balance, both as a share of GDP.

The U.S. debt ceiling deal has taken the near-term risk of default off the table. Yet the fiscal situation remains challenging, in our view. Total public debt as a share of GDP has jumped to around double the level in 2005 (left chart). The budget deficit is also already large (right chart) at a time when the economy is overheating. The debt deal doesn't really change this picture, we think. The spending cuts are a fraction of what was cut in the last debt ceiling showdown in 2011: about 0.3% of GDP, according to the Congressional Budget Office, compared with 1% in 2011. We don't see spending cuts dragging on growth in the same way as a result. But we do think higher-for-longer interest rates will raise debt servicing costs and could leave debt levels growing in this new macro regime. We have said the market focus would move back to the macro picture after the debt ceiling deal – now the Federal Reserve and stubborn inflation are retaking the spotlight.

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The pandemic shocked U.S. labor supply, creating worker shortages. The labor market remains extremely tight, as confirmed in the latest payrolls data, with workforce participation not having improved. That is keeping core inflation sticky. This has presented the Fed with a sharp trade-off: crush growth with even higher rates or live with some inflation. We think the Fed will have to keep policy tighter. Markets have already started to mull the possibility of another rate hike even after the Fed signaled a potential pause. Markets are no longer pricing in repeated Fed rate cuts, waking up to our long-held view that rates are likely to stay higher for longer to combat persistent inflation.

Attention could also eventually shift to the broader U.S. fiscal position with rates staying higher, in our view. The relatively smaller spending cuts in the U.S. debt ceiling deal aren't likely to put a dent in the debt load, in our view. They stand in stark contrast with the aftermath of the 2008 financial crisis when the focus swiftly shifted to fiscal austerity. Interest rates were near zero then and debt servicing costs were at record lows. But now rates have jumped in the fastest rate hiking cycle since the 1980s.

Higher rates mean higher debt servicing costs. We think persistent inflation and high debt levels could cause investors to demand more compensation for holding U.S. assets over time, especially long-term Treasuries.

We also expect a burst of Treasury-bill issuance as the government seeks to replenish the money drawn down since the debt ceiling was hit earlier in the year. We estimate bill issuance could balloon to as much as $1 trillion in the next few months – well above normal issuance levels outside of past crises like the 2008 financial crisis and the pandemic. That could add to volatility in fixed income, in our view, especially in the very short-dated maturities. We tweak our preference for short-term Treasuries as a result, extending the preferred maturities beyond short-term paper to encompass two-year Treasury notes that have repriced in recent weeks.

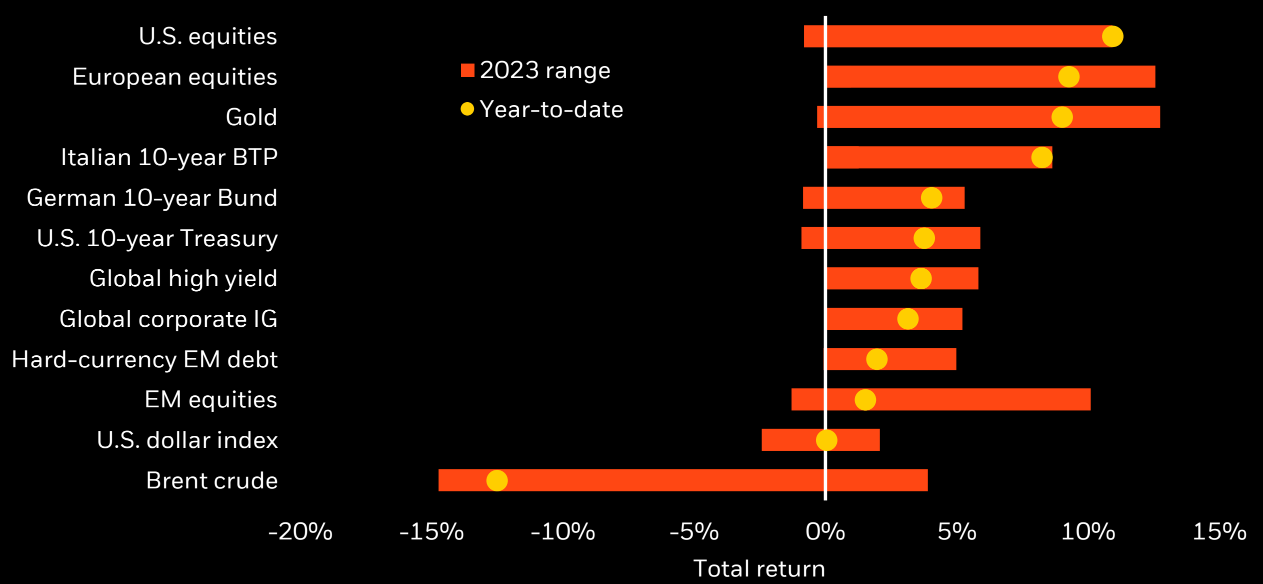
Bottom line: The U.S. debt ceiling deal removes near-term uncertainty – we now expect markets to focus on the macro picture. We see higher-for-longer rates, so we keep our quality tilt in equities and bonds and prefer income for now. We like short-term Treasuries, emerging-market local currency debt and inflation-linked bonds.

Market backdrop

U.S. stocks climbed to 2023 highs after the debt ceiling deal. Yields rose as markets eyed more rate hikes after Friday's payroll report showed a jump in new jobs. The number of jobs added in May was well above market expectations. But the unemployment rate rose with no improvement in labor force participation. We don't think the labor shortage is easing, so wage growth remains elevated. We think that will keep core inflation sticky – and makes rate cuts this year unlikely.

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 June 1, 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

Last week's U.S. jobs report showed 339,000 new jobs were created in May, way above expectations of 195,000. Unemployment rose to 3.7% from 3.4% but the employment-to-population ratio – the share of the total population in work – was little changed. See the chart. That means labor supply hasn't increased. The worker shortage doesn't appear to be easing.

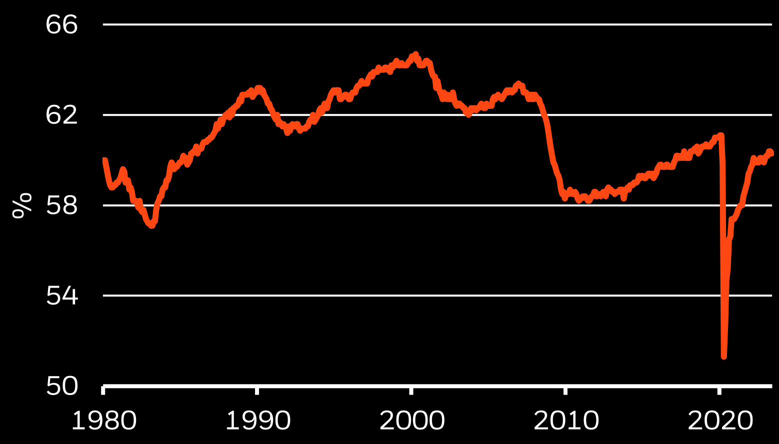
The labor shortage persisting means pay growth isn't slowing down either. Average hourly earnings grew by around 4% in May, still too high to see inflation come back down to the Fed's 2% target. But this measure doesn't adjust for the pandemic's impact on the services sector. The employment cost index (ECI) measure does, and it shows wages rising even more quickly.

This is still a very tight labor market, beset by shortages, and this report leaves the possibility of further Fed hikes firmly on the table, in our view.

Explore our recent Macro take blog posts here.

Sustained labor supply shortage

Employment-to-population ratio, 1980-2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, June 2023. Notes: The chart shows the U.S. employment-to-population ratio – the proportion of a country's working age population that is employed.

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 now evident in the financial cracks emerging from higher interest rates on top of 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.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve signaled a pause after hiking rates in May. But it also reiterated that persistent inflation means no rate cuts this year. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **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.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- 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 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 Fed's rapid 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

June 5	China services PMI; U.S. ISM services PMI	**June 9**	China CPI and PPI
June 7	China trade data	**June 9-16**	China total social financing

China macro data is in focus this week as the restart loses steam. We now expect GDP growth to be a bit below 6% this year rather than slightly above as momentum slows and policy reactions remain uncertain. Deflationary pressures and weaker growth increase the odds of potential policy easing, but we think targeted support for sectors like real estate is more likely.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, June 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' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	Neutral	Neutral	Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than 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 stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're 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	Neutral	—	We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, 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, June 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 and healthcare.
	United States	-1	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	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.
	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.
	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.
	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.
	Short U.S. Treasuries	+2	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	Neutral	We are neutral. We find gilt yields attractive as they have risen back near levels reached during 2022's budget turmoil. We prefer short-dated gilts for income.
	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
	Emerging local currency	+1	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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