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Weekly commentary

BlackRock

April 4, 2022

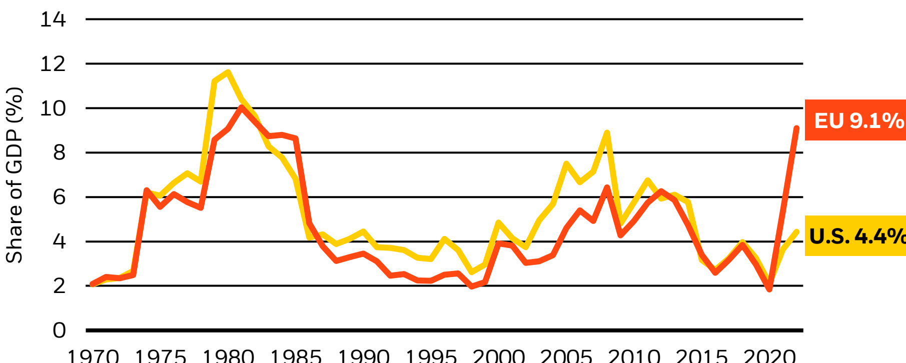
Impact of the drive for energy security

- We see the West's drive for energy security slowing growth, increasing inflation and stoking demand for non-Russian fossil fuels to alleviate consumer pain.
- Data last week showed U.S. inflation at 40-year highs and a robust labor market. We expect the Fed to deliver on this year's projected rate rises and then pause.
- Global activity gauges this week may show how surging commodities prices are affecting global economies. We see Europe as most vulnerable to the shock.

The West is trying to wean itself off Russian energy in the wake of the tragic war in Ukraine. We see this hurting growth and increasing inflation in the short term. More supply of U.S. and other non-Russian fossil fuels will be needed to alleviate pressured consumers. This is a shift in global supply, not an increase. The drive for energy security should reinforce the transition to net-zero carbon emissions in Europe, and we see the transition's speed now diverging more across regions.

Europe's energy conundrum

Energy burden as a share of GDP, 1970-2022



Sources: BlackRock Investment Institute and BP Statistical Review of World Energy 2021, with data from Haver Analytics. April 2022. Notes: The chart shows the cost of oil, gas and coal consumption in the European Union and U.S. as a share of GDP. We use regional energy prices and divide by GDP in U.S. dollars. Data for 2022 are based on IMF's latest GDP forecasts and the year-to-date average of daily commodities prices.

The war in Ukraine is taking a horrible human toll, upending lives, and resulting in food and energy insecurity around the world. It has spurred a drive to secure energy supplies and led to price spikes – presenting a fresh supply shock in a world that was already shaped by supply. Among developed markets, the situation is acute in Europe. A surge in European energy prices means the region is now spending almost a tenth of its GDP on energy, the highest share since 1981. See the red line in the chart. This is why we think the impact of the energy shock will be greatest in Europe, and we see a risk of stagflation there. See Taking stock of the energy shock of March 2022 for full details. The U.S.'s energy burden (yellow line) is less than half Europe's. We expect the energy shock to hit U.S. consumers and businesses, but see a much smaller economic impact than in the late 1970s. Why? The economy is more energy efficient these days, and the U.S. is now a net exporter of energy. We see U.S. growth staying above trend, thanks to the strong underlying momentum from activity restarting after the pandemic shutdowns.

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Head – BlackRock Investment Institute

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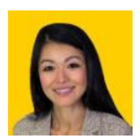

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The scale of the impact depends on the speed at which the West reduces its imports of Russian energy. Our base case is a steady reduction as the West and Russia enter a protracted standoff. Further escalation of the Ukraine war could speed this up. An easing of tensions could slow the process but is unlikely to stop it.

All this means Europe will need greater amounts of gas and other fossil fuels from the U.S. and elsewhere. The massive gap cannot be filled fast enough by ramping up the supply of renewables and nuclear energy or reducing demand via efficiency and conservation measures. Fossil fuel output in the U.S. and elsewhere needs to rise to make up for the shortfall caused by the effective stranding of Russian production. It is a shift in fossil fuel production, not an increase in demand.

This doesn't mean the net-zero transition is being derailed, in our view. The world needs fossil fuels to meet current energy demands, given the way economies are wired today. At the same time, high energy prices ultimately reinforce the drive to cut carbon emissions. Why? They act as a sort of carbon tax on consumers, make renewables more competitive, and spur energy efficiency and innovation. Higher energy prices will hurt U.S. consumers as well, but also herald increased U.S. fossil fuel output. As a result, we may not see the same impetus to reduce emissions there as in Europe. Conclusion: We see the transition's path diverging even more across regions.

What does all of this mean for investments? On a tactical horizon, we are underweight government bonds and prefer equities over credit in the inflationary environment. Many DM companies have been able to pass on rising costs, and we see low real rates, the restart's economic growth cushion and reasonable valuations favoring equities. We have cut our overweight to European equities as we see the energy shock hitting that region hardest. Also, prices have rebounded from the year's lows. In addition, we see the shock creating investment needs in both traditional energy and renewables in the near term. The transition requires the world to go from shades of brown to shades of green, in our view.

On a strategic horizon, we have long argued that a tectonic shift of investor preferences toward sustainability would trigger a great repricing of assets across the board over time. This is why we incorporated climate change in our return and risk assumptions. We now have evidence of this repricing, and believe most of it is yet to come. This doesn't mean sustainable assets always go up – but we believe it should add to their performance over time.

Market backdrop

U.S. inflation data for February showed price increases hovering near 40-year highs. The report showed a further rotation back to services spending as the economy, and away from goods spending. Jobs data showed a robust labor market. We see the Fed normalizing policy and delivering on its projected rate path this year but then pausing to evaluate the effects on growth. We believe the eventual sum total of rates in this cycle will be historically low, given the level of inflation.

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 March 31, 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.

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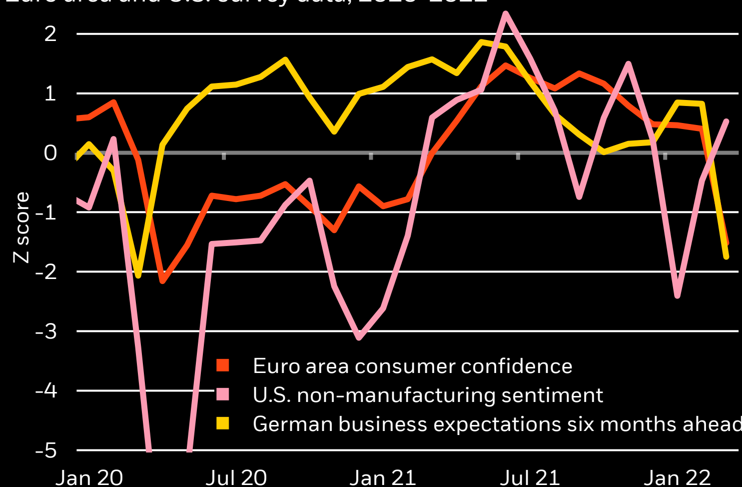
Macro insights

The fallout of the war in Ukraine looks set to hurt economic activity in Europe substantially more than in the U.S. Consumer confidence in the euro area has taken a knock almost as big as it faced at the start of the pandemic, as the orange line in the chart shows. European businesses also appear less confident about the next six months. A survey of German firms by the Ifo Institute reveals the sharpest decline in expectations on record (yellow line). The reverse is true in the U.S. A Philadelphia Fed survey of non-manufacturing companies shows a pick-up in sentiment (pink line).

This aligns with our view that the European economy is more at risk than the U.S. from the commodities shock. It also shows the shock is broader than the effect of higher energy prices alone. For example, supplies of key production components such as car parts have been disrupted, posing extra risks for manufacturers. Plus, dented confidence can drag down consumer spending and business investment. We think consumers are now less likely to spend excess savings built up during the pandemic. See our macro insights.

European sentiment plunges

Euro area and U.S. survey data, 2020-2022



Sources: BlackRock Investment Institute, with data from Haver Analytics, April 2022. Notes: The survey data are expressed in terms of standard deviations away from mean, calculated over the period 2000-2019 (or later if the data history is shorter).

Investment themes

1 Living with inflation

- We expect central banks to quickly normalize policy. We see a higher risk of the Federal Reserve slamming the brakes on the economy to deal with supply-driven inflation after raising rates for the first time since the pandemic.
- The Fed has projected a large and rapid increase in rates over the next two years. We see the Fed delivering on its projected rate path this year, but then pause 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.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation. DM central banks have already demonstrated they are more tolerant of inflation.
- The Bank of England hiked rates for a third time but signaled that it may pause policy normalization on concerns about the growth outlook from spiraling energy costs. This is the bind other central banks will likely face this year.
- The European Central Bank has also struck a hawkish tone, planning to wind down asset purchases and leaving the door open for a rate increase later this year. We expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- **Investment implication**: We prefer equities over fixed income and overweight inflation-linked bonds.

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 aggressively 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.
- The sum total of expected rate hikes hasn’t changed much even with the Fed’s hawkish shift.
- **Investment implication:** We have tweaked our risk exposure to favor equities at the expense of credit.

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 fossil fuels 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 DM equities over EM as we see them as better positioned in the green transition.

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Week ahead

April 5	U.S. ISM non-manufacturing PMI; Global composite PMIs	**April 6**	Fed minutes; Poland central bank meeting; China Caixin Services PMI

Purchasing Managers' Index reports this week will enable investors to to gauge how surging commodities prices are affecting global economies. We believe the war will weigh materially on European economic activity as the region tries to wean itself off Russian energy. We see the impact on U.S. activity as muted for now. Read A new supply shock for details

Directional views

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

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

Asset	Strategic view	Tactical view	
Equities	+2	+1	We increased our strategic equities overweight in the early 2022 selloff. We saw an opportunity for long-term investors in equities because of the combination of low real rates, strong growth and a change in valuations. 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 favor developed market equities over emerging market stocks, with a preference for the U.S. and Japan over Europe.
Credit	-1	-1	We are underweight credit on a strategic and tactical basis against a backdrop of rising interest rates and high valuations. We prefer to take risk in equities instead. Tactically, 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 given their diminished ability to act as portfolio diversifiers with yields near lower bounds. 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.

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Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, April 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	+2	We overweight DM stocks amid supportive fundamentals, robust earnings and low real yields. We see many DM companies well positioned in the inflationary backdrop thanks to pricing power. We prefer the U.S. and Japan over Europe.
United States	+2	We overweight U.S. equities due to still strong earnings momentum. We see the Fed not fully delivering on its hawkish rate projections. We like the market's quality factor for its resiliency to a broad range of economic scenarios.
Europe	+1	We are moderately overweight European equities as we expect the energy shock to hit European growth hard. We like the market's cyclical bend in the inflationary backdrop and expect the ECB to only slowly normalize policy.
UK	Neutral	We are neutral UK equities. We see the market as fairly valued and prefer other DM equities such as U.S. and Japanese stocks.
Japan	+2	We are overweight Japan equities on supportive monetary and fiscal policies – and the prospect of higher dividends and share buybacks.
China	+1	We now see Chinese stocks as more risky, but improved valuations leave us moderately overweight. China's ties to Russia have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.
Emerging markets	Neutral	We are neutral EM equities and prefer DM equities, given more challenged restart dynamics, higher inflation pressures and tighter policies in EM.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China because of easing monetary and regulatory policy.
U.S. Treasuries	-1	We underweight U.S. Treasuries even as yields have surged this year. We see long-term yields move up further as investors demand a higher premium for holding governments bonds. We prefer short-maturity bonds instead.
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	-1	We underweight European government bonds. We see yields heading higher even as markets have adjusted to price in an end to negative rates and beyond.
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	+1	We overweight Chinese government bonds. Easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
Global investment grade	-1	We underweight investment grade credit amid tight spreads and interest rate risk. We see more value in equities instead.
Global high yield	Neutral	We are neutral high yield. We do not expect credit spreads to tighten but find the income potential attractive. We prefer to take risk in equities.
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	+1	We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income.

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