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Weekly commentary

February 22, 2022

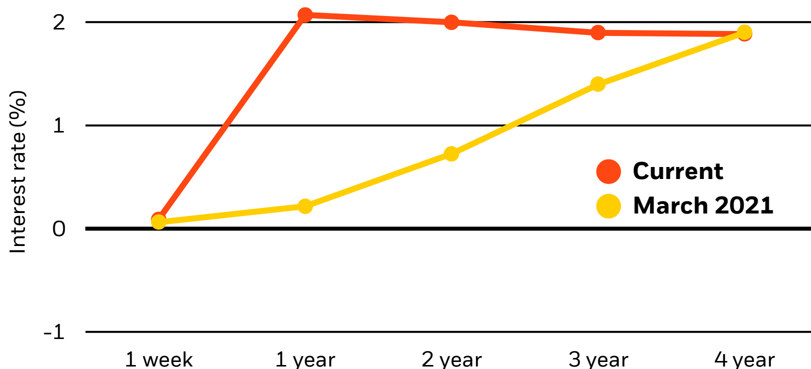
Confusion yields opportunity

- We up our strategic overweight to developed market (DM) equities, but near term elevated geopolitical tensions keep our tactical shopping basket on hold.
- Equities retreated as investors took renewed fright over the military stand-off involving Ukraine, helping pull down short-term bond yields from recent peaks.
- The market's focus this week will be on PCE inflation, the Fed's inflation target, for clues on the timing and magnitude of coming rate hikes.

The situation on the Russia-Ukraine border keeps escalating as President Vladimir Putin ordered troops into eastern Ukraine after recognizing breakaway regions as independent, adding to confusion about the macro and policy outlook. Heightened geopolitical risks keep us from adding risk tactically, even as we see central bank hawkish repricing as overdone. Yet we see an opportunity for long-term investors to raise equity allocations to position for the regime shift we see unfolding.

Hawkish repricing

Market pricing of future Fed policy rates, current vs. March 2021



Sources: BlackRock Investment Institute, with data from Bloomberg, February 2022. The chart shows the pricing of expected central bank policy rates via 1-year forward overnight index swaps. For example the last point on each chart shows the one-year OIS rate four years ahead.

Strategically, our asset views – a broad preference for equities over nominal government bonds and credit – have been positioned for the new market regime that we flagged in our 2022 Global Outlook. We see this regime being driven by investors demanding greater compensation, or term premium, for the risk of holding government bonds and our expectation for higher inflation in the medium term. It reinforces a significant reallocation to equities and away from government bonds that has only just begun, in our view. We push back against the notion that the recent pulling forward of rate hike timing and higher bond yields imply lower equity valuations. The cumulative path of rate hikes matters more for valuations than the speed of repricing over the next few years and that path hasn't materially changed. See the chart. Accounting for the low path of expected rates, equity valuations are not as stretched as traditional metrics suggest, such as price-to-earnings ratios. The equity risk premium – our preferred valuation gauge that considers the outlook for rates and earnings – is in line with its historical average.

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Markets have also been on tenterhooks due to the Russian military threat to Ukraine. It reflects the most serious security challenge in Europe since the end of the Cold War. We believe some form of Russian military action and an extended stand-off are increasingly likely. Such action could trigger Western sanctions, military aid to Ukraine and an increased NATO presence in eastern Europe. This evolving situation warrants near-term caution. Yet we are also mindful that geopolitical tensions tend to cause short-term gyrations like the ones we're seeing rather than become ongoing market drivers.

Beyond these tensions, we believe the risk asset pullback is due to markets adjusting to a regime shift and the confusion stemming from the unusual economic restart, a supply-driven surge in inflation and new central bank frameworks. Central banks will likely only return policy to pre-Covid settings rather than aggressively fight inflation. Why? Because this is not your usual inflation. Supply factors are the main drivers rather than the more typical scenario of high demand in an overheating economy. DM economies still have room to grow. So aggressive rate hikes to stamp out supply-driven inflation would only torpedo economic activity that has not yet fully recovered. That's why we think they will choose instead to live with inflation and only raise rates to remove stimulus that is no longer needed. This should keep real, or inflation-adjusted, yields low and is why we are looking to lean into tactical opportunities. The market may sometimes itch for a bigger policy response to inflation, but this matters more from a trading than a long-term investment perspective.

With that in mind, we believe equity markets are not making the distinction between the repricing in the near-term path of policy rates, which has been sharp yet has a limited impact on long-term expected returns, and the muted change in long-run rate expectations – far more important for equity valuations and returns. The sum total of expected rate hikes over the cycle - key for asset valuations - has not moved materially, particularly in the U.S. That means equities have become more attractively valued than they were prior to the selloff. See more on page 4. Over the long-term, we also see the net-zero transition driving a relative return advantage for "greener" sectors, such as tech and healthcare, over "browner" sectors, such as energy and utilities.

Strategically, we remain underweight DM government bonds. First, we expect yields to move higher as investors demand a greater term premium. Second, yields are close enough to effective lower bounds to limit their role as portfolio ballast in risk-off environments. Tactically, we also see yields moving higher – but also see the hawkish repricing as overdone.

Market backdrop

Equity markets were mildly weaker as the threat of a Russian invasion of Ukraine dominated headlines, with the U.S. government warning of potential imminent action. We see a range of possible actions that Russia could take, including cyber-attacks or other destabilizing actions, military incursions into Ukraine territory, all the way up to a full-scale invasion. U.S. Treasury yields pulled back from recent highs, and crude oil prices fell after reaching an eight-year peak.

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 February 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

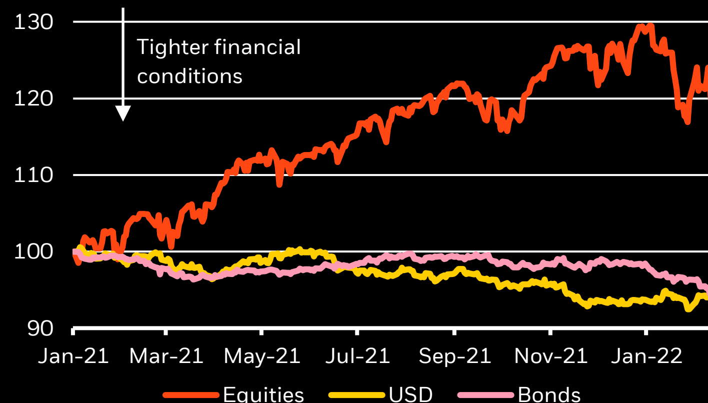
Financial conditions have tightened across developed markets in recent months – in other words, financing is becoming more costly for firms, households and governments. Tighter financial conditions typically slow down economic growth.

What's causing them to tighten? Primarily a shift in tone by central banks that has led markets to expect a faster pace of interest rate hikes. Yet markets have not really changed their view of cumulative rate hikes, at least in the U.S., so the tightening has been contained so far. It is also important to view the tightening through the lens of the post-pandemic restart, rather than as the main determinant of growth like in a typical business cycle. The restart doesn't require stimulus, so some tightening is unlikely to weigh materially on growth.

We do not expect central banks to actively engineer further tightening by raising rates to restrictive levels – but there is the risk that financial conditions could tighten further if markets misinterpret their policy intentions. See our macro insights hub.

Tighter financial conditions

U.S. financial conditions, 2021-2022



Sources: BlackRock Investment Institute, February 2022. Note: The chart shows the level of equity total returns (orange), the trade-weighted exchange rate (yellow) and bond index (pink). The equity index used is the S&P 500 total return index and the bond index used is the Bloomberg Aggregate index. All series are expressed so that a decrease denotes a tightening in financial conditions and indexed to be 100 on Jan. 1, 2021.

Investment themes

1 Living with inflation

- We expect inflation to be persistent and settle above pre-Covid levels. We expect central banks to kick off rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.
- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many supply-demand imbalances to resolve over the year.
- The policy response to rising inflation isn't uniform. Developed market (DM) central banks have already demonstrated they are more tolerant of inflation, even as several are gearing up to kick off rate hikes with steeper initial increases. The Bank of England and many emerging market (EM) counterparts have already lifted off.
- The Fed has achieved its new inflation goal to make up for past misses and sees it has met its full employment mandate. This is the justification for kicking off rate hikes soon, likely in March. Still, we believe the total sum of hikes is unchanged and historically muted – and that's more important to markets.
- The Fed has sped up its tapering of bond purchases and has indicated it may start to trim its balance sheet earlier than expected by letting bonds run off when they mature. The European Central Bank has also indicated it may wrap up its asset purchases earlier than expected.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- A 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 keep the big picture in mind: We see the restart rolling on, inflation meeting a muted central bank response, and real rates remaining historically low.
- We do see increasing risks around this base case: Central banks could revert to their old policy response, and growth could surprise on the upside or disappoint.
- There's also a risk markets misread China's policy. The country has emphasized social objectives and quality growth over quantity in regulatory crackdowns that have spooked some investors. Yet policymakers can no longer ignore the growth slowdown, and we expect incremental loosening across three pillars – monetary, fiscal and regulatory.
- **Investment implication:** We have trimmed risk-taking amid an unusually wide range of outcomes.

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.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. 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

Feb. 21	Global flash PMIs for February	**Feb. 25**	U.S. January PCE inflation and spending
Feb. 22	U.S. flash PMI for February		

Developments on Russia's military buildup around Ukraine will likely remain a market focus. Global flash purchasing managers' indexes will give some color on whether supply chain bottlenecks are getting resolved. The key data point will be the U.S. January PCE inflation index to see how the higher-than-expected jump in the January U.S. CPI to a fresh 40-year peak translates into the inflation gauge targeted by the Fed – and what it means for rate hikes expected to start in March.

Directional views

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

Underweight | Neutral | Overweight

Change in view: Previous → New

Asset	Strategic view	Tactical view	
Equities	+2 (changed from +1)	+1	We add to our strategic overweight on equities. The early 2022 selloff creates a compelling opportunity for long-term investor as we see the combination of low real rates, strong growth and reasonable valuations as favourable for the asset class. 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 overweight equities amid solid economic fundamentals and historically low real rates.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich, and we prefer to take risk in equities instead. On a tactical horizon, we are neutral credit given low spreads across sectors and prefer EM local markets to high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. We see the long-term outlook for the asset class challenged by rising term premium and our expectation of higher medium-term inflation than markets are pricing. We prefer inflation-linked bonds. Tactically, we recently reduced our underweight to U.S. Treasuries – we see the direction of travel for yields as higher but think the move is overdone for now. We prefer inflation-linked bonds for interest rate exposure and as a portfolio diversifier.
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, February 2022

Underweight | **Neutral** | **Overweight**

Change in view: Previous → New

	Asset	Underweight	Overweight	
Equities	**Developed markets**		■	We are overweight developed market equities. We see still solid growth and low real yields supporting valuations. We prefer to diversify our exposure.
	United States		■	We are overweight U.S. equities on still strong earnings momentum. We do not see gradual policy normalization posing significant headwinds.
	Europe		■	We stay modestly overweight European equities given attractive valuations. We believe the rise in Covid infections may stall but not derail the restart
	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
	Japan		■	We have a small overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
	China		■	We stay moderately positive on Chinese equities as we see a shift to a slightly easier policy. We expect the regulatory clampdown to last but not intensify.
	Emerging markets			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
Fixed Income	U.S. Treasuries	■		We recently reduced our underweight to U.S. Treasuries given the yield surge so far this year. Over a longer horizon, we see higher yields as investors demand a higher premium for holding governments bonds.
	Treasury Inflation-Protected Securities		■	We stay overweight U.S. TIPS as we expect inflation to be persistent and settle at a higher level than pre-Covid. We prefer TIPS for interest rate exposure and diversifiers.
	European government bonds	■		We are underweight on government bonds. We see yields heading higher even as market pricing has adjusted sharply to price in an end of negative rates and beyond.
	UK gilts			We are neutral UK Gilts. We see UK policy rates rising before DM peers, yet believe market expectations of the subsequent pace are overdone amid constrained supply.
	China government bonds		■	We are overweight Chinese government bonds. Potentially easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
	Global investment grade	■		We stay underweight investment grade credit. We see little room for further yield spread compression and remain concerned about interest rate risk.
	Global high yield			We are neutral high yield. We do not see compression in high yield spreads yet still find the carry attractive. We prefer to take risk in equities.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency		■	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.
	Asia fixed income		■	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 and carry.

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