Weekly commentary

March 7, 2022

BlackRock

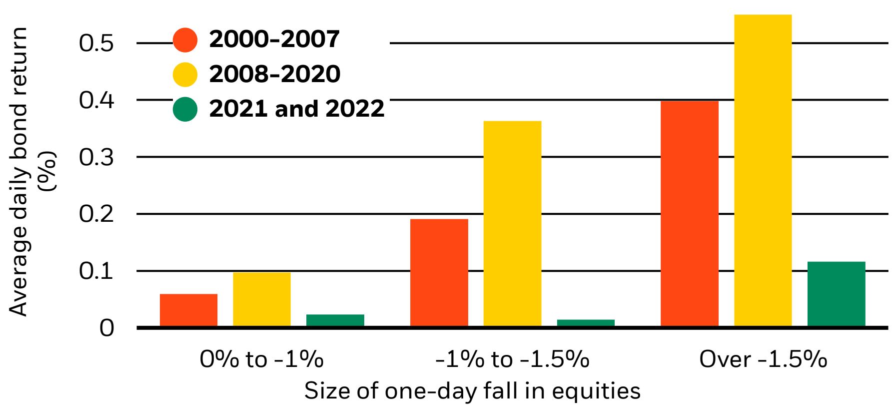
Why we stay underweight bonds

- We see developed market (DM) government bonds as ineffective portfolio diversifiers and favor inflation-linked bonds in this inflationary environment.
- Energy prices surged on further supply concerns. Equities slid, with Europe harder hit than the U.S. Bond yields fell on reduced rate hike expectations.
- The European Central Bank will likely emphasize the need to assess how higher energy prices will hurt activity, suggesting less for it to do to normalize policy.

Government bonds have shown some traditional diversification properties since Russia's invasion of Ukraine last month. Yet our work shows that government bonds historically offer less diversification during periods of supply-driven inflation such as we're seeing now and exacerbated by the conflict. We stay strategically and tactically underweight DM nominal government bonds and look for diversification in inflation-linked and Chinese government bonds (CGBs).

Reduced diversification

Average 10-year U.S. Treasury returns on days when equities fall, 2000-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2022. The chart shows average daily return on the benchmark 10-year U.S. Treasury on days when the MSCI World equity index fell between 2000-2007(orange bars), 2008-2020 (yellow bars) and in 2021-2022 (green bars) .

Russia's invasion of Ukraine came just as investors had become excessively hawkish about central bank policy expectations, in our view. The broad rise in yields across the curve had created some yield cushion just before a global risk-off move sparked by a major geopolitical event. In the short period since the conflict started to escalate, government bonds briefly helped guard portfolios against some equity losses. Yet we see this diversification role as increasingly challenged due to supply-driven inflation and central banks' higher tolerance of such inflation. Market performance suggests so as well. The chart shows average daily returns in U.S. 10-year Treasuries on days when the MSCI World index of DM equities fell. The contrast in performance of Treasuries between 2000-2020 (red and yellow bars) and the past 14 months (green bars) has been stark, particularly on days when stocks fell over 1.5%. We prefer Treasury inflation-protected securities (TIPS) relative to nominal Treasuries to provide duration exposure and as a relative play on market pricing of higher inflation.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist – BlackRock Investment Institute

Vivek Paul
Senior Portfolio Strategist – BlackRock Investment Institute

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The correlation of stock and bond returns is key in assessing bonds' ability to play the role of portfolio diversifiers. Our analysis of the stock-bond correlation and macro factors such as growth and inflation in the U.S. since the mid-1960s reveals a key link between the two. We find that the correlation is typically negative when demand shocks dominate and positive when supply shocks are the driving force. In other words, bonds are less likely to act as portfolio ballast during equity selloffs in a world shaped by supply constraints – what's happening now and we see persisting in coming years.

The Russia-Ukraine war will have long-term humanitarian and geopolitical consequences. We see high energy prices as the main macro transmission channel – exacerbating supply-driven inflation in the near-term. This is particularly evident in Europe where coal, electricity and natural gas prices have surged from already elevated levels. Higher energy costs will take a toll on growth – more starkly in the euro area than the U.S. given geographical proximity, deeper economic linkages and energy dependency on Russia. The relative impact may push up U.S. long-term yields more than euro area yields.

All this complicates the dilemma central banks were already facing. With a commodity price shock adding to a persistent inflation narrative, we think central banks will need to carry on with policy normalization. We used to see the possibility of central banks slamming the policy brakes as the biggest risk. But that risk is now reduced due to the higher cost of slowing growth, especially in Europe. This for now supports our overweight to DM equities, which we twinned with an underweight to credit. To balance this exposure in a whole-portfolio context, we seek alternatives to nominal government bonds, particularly given our view that the risk of inflation expectations becoming unanchored is going up over time. We see more appeal in assets such as TIPS – for duration as well as relative exposure to inflation – and CGBs. Our work finds TIPS and CGBs offer better risk-adjusted returns and lower correlation to equities than other assets of broadly comparable risk.

Bottom line: Our preference for equities over both government bonds and credit keeps us positioned for a new market regime – one of investors demanding greater compensation, or term premium, for the risk of holding government bonds and one where we expect higher inflation in the medium term than markets are pricing. We retain our underweight on DM nominal government bonds on both a tactical and strategic horizon. Last month we downgraded credit – where valuations remain rich given how well spreads have held up and because of the duration risk from a renewed rise in long-term yields. Historically low and negative real yields reinforce our overweight to DM equities. We remain overweight TIPS and stay modestly overweight Chinese assets, and we like CGBs in particular for both returns and diversification.

Market backdrop

Crude oil prices shot up to around $120 a barrel and European natural gas prices doubled to hit record highs on concerns about supply. Both Russia and the West have avoided weaponizing energy, but we see the risk is rising as the conflict deepens. Equity markets fell, with Europe underperforming the U.S. Euro area inflation hit a new record high in February. The ECB this week will likely emphasize the need to assess how higher energy prices will hurt activity.

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 3, 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.

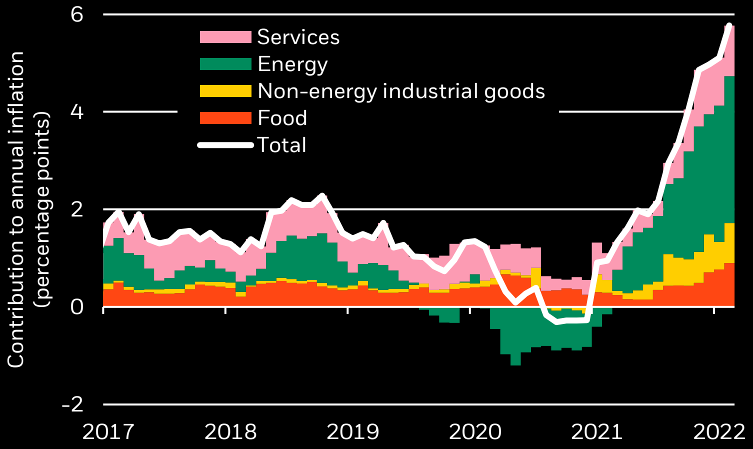
Macro insights

Rising energy prices have been the main driver of euro area inflation over the last 12 months – and the Russia-Ukraine conflict now exacerbates this. See the green band in the chart. We estimate last week's spike in oil and gas prices could add materially to euro area headline inflation over 2022. The impact in the U.S. is likely to be smaller as it is significantly less reliant on energy from the region. Combine this with an additional hit to agricultural and intermediate supplies – like palladium and car parts – and the conflict is adding to the supply shock that was already in train.

Supply-driven inflation makes life difficult for central banks: aggressive rate hikes will do nothing to curb the pass-through of higher energy prices. Either they accept higher inflation or destroy economic activity to contain it. That's why we believe – even more now – that central banks will go ahead with cautiously removing the pandemic stimulus that's no longer needed, but will not go further to squeeze out inflation. We already see markets adjusting their expectations to reflect this reduced likelihood of aggressive hiking, especially in the euro area. See our macro insights hub.

Energy-driven inflation

Breakdown of euro area HICP inflation, 2017-2022



Sources: BlackRock Investment Institute, Eurostat, with data from Haver Analytics, March 2022. Notes: The chart shows the contribution of different goods and services to headline inflation in the euro area. The bars denote percentage point contributions to headline HICP inflation. Data for February 2022 are based on the euro area HICP inflation flash release and may be revised.

Investment themes

1 Living with inflation

- We expect central banks to carry on with policy normalization, and we see a reduced risk of them slamming on the brakes to deal with this inflation. Politically, it's easier to blame inflation on the conflict and argue that monetary policy can do little about it, for now, in our view.
- But the risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent. And the problem is that inflation expectations are anchored until they're not. The policy response to rising inflation isn't uniform.
- DM central banks have already demonstrated they are more tolerant of inflation.
- The Fed is poised to start hiking rates later this month. But the total sum of hikes priced in is unchanged and historically muted – and that's more important to markets.
- The European Central Bank is likely to strike a flexible stance on policy normalization given the risk to growth from higher energy prices.
- **Investment implication**: We prefer equities over fixed income and remain 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 at start the year.
- The Russia-Ukraine conflict has compounded the inflation picture. Yet we still think the response to inflation will be historically muted as central banks focus on getting policy rates closer to neutral.
- So far the sum total of expected rate hikes hasn't changed, even as markets have cooled expectations of higher rates in the near term.
- **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.
- 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.

Week ahead

March 7	China trade data
March 10	ECB policy decision, U.S. Consumer Price Index
March 11	U.S. University of Michigan consumer sentiment data

The ECB meets this week against the backdrop of Russia's war with Ukraine and soaring energy prices. While updated ECB forecasts are likely to show materially higher inflation and lower growth, we believe the conflict lowers the risk that the ECB starts to raise policy rates soon – and it may even keep up bond purchases for longer. The U.S. CPI is likely to show few signs of peaking yet, with the headline index seen pushing to a new 40-year high near 8%.

Directional views

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

Underweight **Neutral** **Overweight**

Change in view
Previous New

Asset	Strategic view	Tactical view	
Equities	+2	+1	We added to our strategic equities overweight in February. The early 2022 selloff created an opportunity for long-term investors as we see the combination of low real rates, strong growth and reasonable valuations as favorable 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	-1	We are underweight credit on a strategic and tactical basis against a backdrop of rising long-end rates and high valuations. We prefer to take risk in equities instead. Tactically, we remain overweight local-currency EM debt.
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 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.

Granular views

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

Underweight | Neutral | Overweight

Change in view: Previous → New

	Asset	Underweight	Overweight	
Equities	**Developed markets**		■■	We increased our overweight on developed market equities last month after this year's pullback. The market's view of rate hikes is overly hawkish, in our view. Solid growth and low real yields support more attractive valuations.
	United States		■■	We raised our overweight in U.S. equities last month due to still strong earnings momentum. We do not see policy normalization posing significant headwinds.
	Europe		■■	We increased our overweight in European equities last month given attractive valuations. We believe the market's view of euro area rate hikes is particularly excessive.
	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
	Japan		■	We are 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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