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Weekly commentary

BlackRock

March 28, 2022

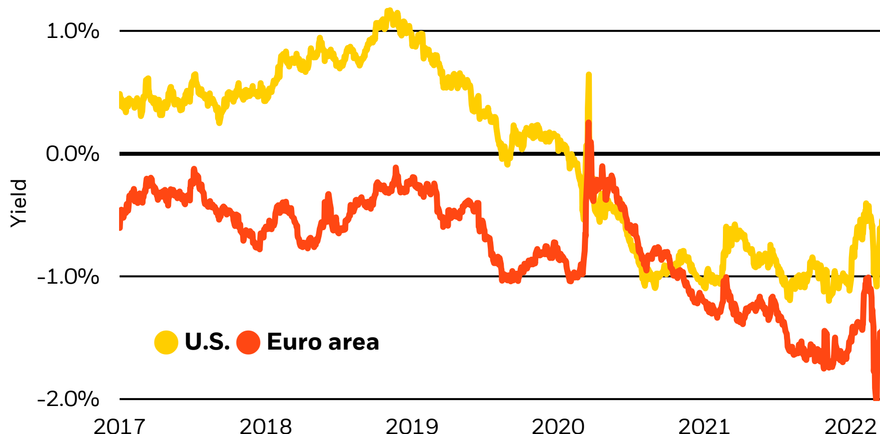
Energy shock, Fed spur new outlook

- We now prefer U.S. and Japanese equities over European stocks due to the energy shock. We stay underweight bonds because of the inflationary backdrop.
- Bond yields sprinted higher last week, with U.S. 10-year Treasuries hitting near three-year highs. Signs of weakening economic activity emerged in Europe.
- U.S. inflation and jobs data this week could guide the Fed in its rate hike path. We believe it will deliver on its hawkish rate projection this year - but then pause.

Much has changed since our 2022 outlook. The tragic war in Ukraine has resulted in a global energy shock. We see this increasing inflation, pressuring consumers and hurting growth, especially in Europe. The Fed has started to talk tough on inflation and has projected a large increase in rates. In our latest outlook update, we remain underweight bonds even as nominal yields have shot up this year, and reduce our European equities overweight in favor of U.S. and Japanese stocks.

Low real yields support equities

10-year real yields in the U.S. and euro area, 2017-2022



Sources: BlackRock Investment Institute, with data from, March 2022. Notes: The chart shows real yields in the euro area (shown as the GDP weighted yield of Germany, France and Italy) and the U.S., based on 10-year inflation-protected government bonds. The real yield strips out the expected impact of inflation over the next decade.

Russia's invasion of Ukraine has taken a horrible human toll and has resulted in a spike in commodities prices that is driving food and energy insecurity. This is dampening economic growth and exacerbating supply-driven inflation, with Europe most exposed among developed markets (DMs) as it tries to wean itself off Russian energy. Rising inflation has kept real, or inflation-adjusted, yields near record lows, as the chart shows, even as nominal yields have sprinted upward. Central banks are scrambling to normalize policy and raise rates this year – but we don't expect them to go quite as far in total hikes as markets currently expect. We expect long-term yields to edge up as investors demand more compensation for the risk of holding bonds amid high inflation. The result? We see more pain for bonds but believe stocks can thrive amid historically low real rates.

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BlackRock **Investment** Institute

Going into 2022, we nudged down portfolio risk as we saw a risk of markets pricing in aggressive central bank actions in an effort to contain inflation. This played out and pushed down both bonds and stocks – faster and harder than we expected. We added to our DM equities overweight at the expense of credit last month on a tactical horizon. Since then, three things have become clear to us: The commodities shock will make inflation even more persistent, the impact differs greatly by region, and central banks actually have made hawkish pivots in response.

Where does this leave our macro outlook? We believe the Fed will go ahead with its projected rate increases for this year, but then will pause as the effect of tightening on growth becomes clearer. We expect that the Fed and other central banks eventually will be forced to live with supply-driven inflation, rather than take policy rates above their neutral level. Doing so would risk destroying growth and employment, in our view. As a result, we expect the sum total of rate hikes to be historically low given the level of inflation. Investors will start to question the perceived safety of government bonds, we believe, against this backdrop of high inflation and debt levels. What are risks to our base case? First, central banks could slam the brakes and cause a recession in an effort to contain inflation. Second, inflation expectations could become unanchored: Markets and consumers could lose faith that central banks can keep a lid on prices. This possibility makes the first risk more real.

All this means that we see more downside risk for government bonds – even as 10-year U.S. Treasury yields are hovering near three-year highs. DM government bonds are less effective portfolio diversifiers in periods when supply shocks dominate, as they do now. Within the asset class, we prefer short-maturity bonds over long-term ones. Markets have been quick to price in the Fed's hawkish rate projections. We think this repricing in short-term rates is overdone as we don't expect the Fed to fully deliver on its projected grand total of rate increases over the next two years.

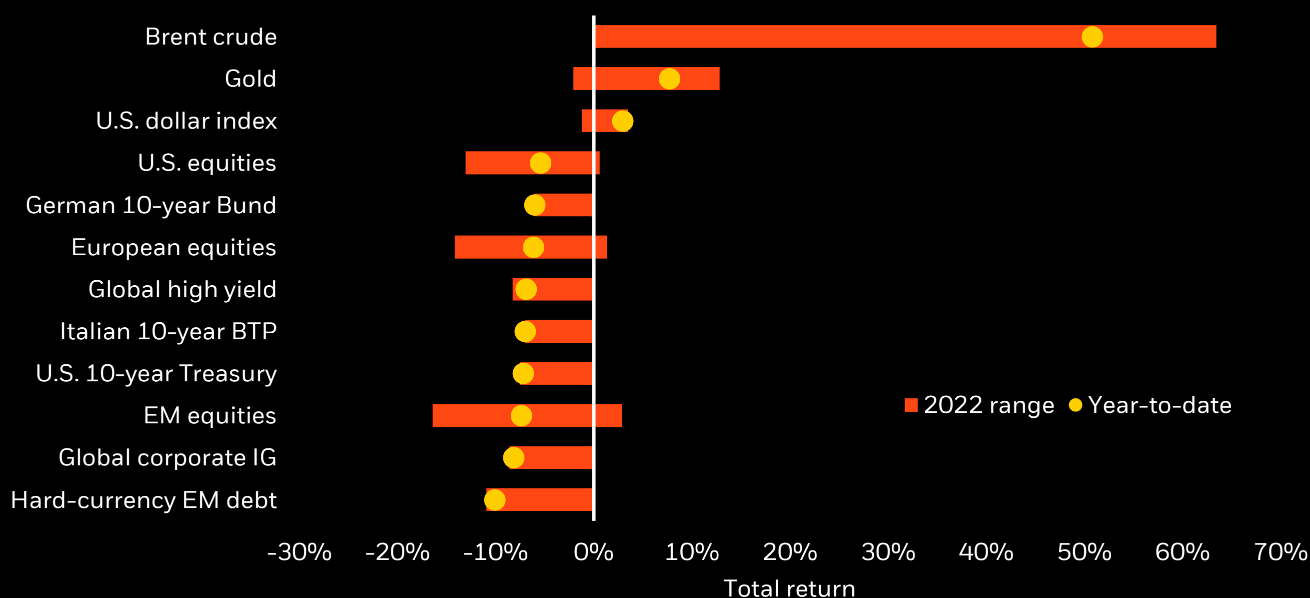
We remain pro risk on a tactical horizon and prefer equities over credit. The inflationary environment favors stocks, in our view, and many DM companies have been able to pass on rising costs and keep margins high. We also like the combination of low real rates, the restart's economic growth cushion and reasonable equity valuations. We reduce our overweight to European equities as we see the energy shock hitting that region hardest. Also, prices have rebounded from the year's lows. Why not shift to an underweight? We expect the European Central Bank to only slowly normalize policy. We increase our overweight to Japanese stocks on prospects of higher dividends and buybacks, and supportive policy. We like the U.S. stock market as we see its quality factor resilient to a broad range of economic scenarios, brightening its appeal.

Market backdrop

Government bond yields climbed last week, with 10-year U.S. Treasuries hitting near three-year highs, before falling back on worries of economic weakness. Data showed the Ukraine war's economic impact is starting to affect economic activity in the euro area. The U.S. economy for now looks resilient, and we prefer U.S. stocks over European ones as a result.

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 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.

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Macro insights

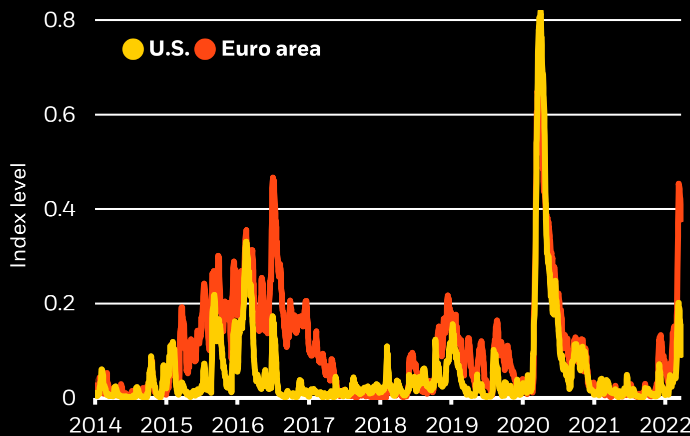
The war in Ukraine has sparked a surge in global energy and commodity prices – the main macroeconomic impact of the tragic conflict so far. The shock is largest in Europe, where natural gas prices shot up more than they did during previous energy price shocks.

Measures of systemic stress in the financial system are now rising – potentially highlighting another channel to transmit the shock. This is most pronounced in the euro area, as the chart shows. Countries with close geographic or commercial ties to Russia, such as Finland, Austria and Netherlands, have seen moves on a par with earlier stressed episodes in 2015-17. The U.S. stress indicator has ticked up, though the overall level remains much more muted than in the euro area.

Further financial stress increases the risk of market dislocations in the euro area. We believe the European Central Bank's policy normalization remains on track, yet the shock's hit to activity could temper the pace and size of interest rate increases. See our macro insights.

Rising stress

Euro area and U.S. financial system stress, 2014-2022



Sources: BlackRock Investment Institute, European Central Bank, March 2022. Notes: The chart shows the ECB's composite index of systemic stress. This monitors a range of mainly market-based financial stress measures. See https://sdw.ecb.europa.eu/browseExplanation.do?node=9689686 for more details.

Investment themes

1 Living with inflation

- We expect central banks to carry on with normalizing policy. We see a higher risk of the Federal Reserve slamming on the brakes 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 struck a hawkish tone earlier this month, 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 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 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

March 31	U.S. consumption and PCE inflation; Czech Republic monetary policy meeting
April 1	Euro area inflation; U.S. employment report

U.S. inflation and employment data may guide the U.S. Fed in the pace of raising rates after it delivered its first hike since 2018. We believe the Fed will deliver on projected rate increases this year but then pause. Inflation data won't reflect the jump in energy and food prices resulting from the Ukraine war, we think. Jobs data are likely to show a post-Omicron boost.

Directional views

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

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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 | ● 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 reduce our overweight in 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 increase our overweight to Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.
China	+1	We stay moderately overweight Chinese stocks as we see a shift to easier policies across the board. China's ties to Russia have created a new geopolitical stigma risk that could pressure some investors to avoid Chinese assets.
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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