Weekly commentary

BlackRock

May 1, 2023

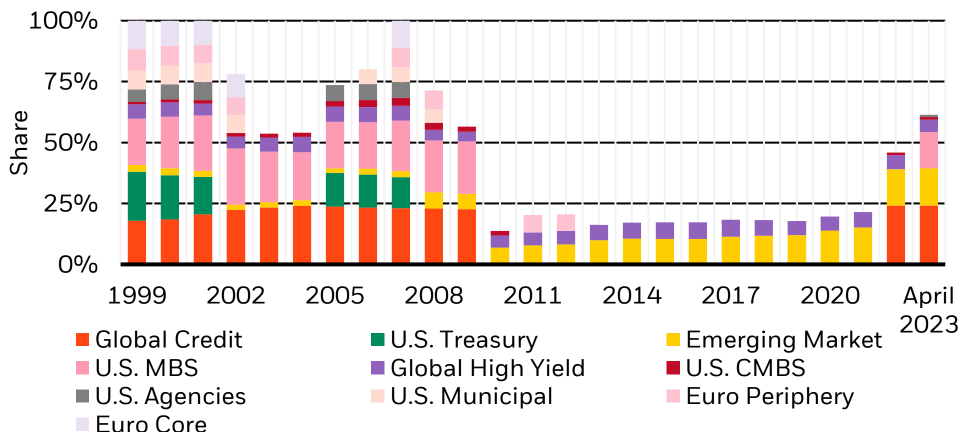
Income in the new macro regime

- We see bond yields staying high in the new macro regime – that means income is back as a portfolio driver. We stay nimble and granular across fixed income.
- U.S. stocks rallied from a four-week low last week after tech earnings beat. Yields fell even as data confirmed slowing growth and persistent wages and inflation.
- This week we see major central banks hiking rates again. We don't see cuts this year. We also expect U.S. jobs data to show a tight market still fueling wages.

Income is back as a portfolio driver as we see interest rates staying high in the new regime of macro and market volatility. We like bonds for income even if we don't expect them to offset risk-asset slides as much as they did in the past – or gain in price from falling yields. We favor very short-term, high-quality government paper and emerging market (EM) local currency debt. We also see value in high-quality credit as we keep risk low on a six- to 12-month tactical horizon.

Yield is back

Fixed income indexes yielding over 4%, 1999-2023



Source: BlackRock Investment Institute, April 2023. Notes: The bars show market capitalization weights of indexes with an average annual yield over 4% in a select universe representing about 70% of the Bloomberg Mulitiverse Bond Index. Euro Core is based on French and German indexes. Euro periphery is based on Italy, Spain and Ireland. Emerging markets combine external and local currency debt. Current calendar year data is not averaged and reflects month-end yield.

Yield is back: The share of fixed income indexes yielding over 4% is at its highest level since 2008 (see the chart). Global investment grade (IG) credit has come roaring back after a long drought (dark orange bars). We like income in bonds as a result. We also like that we can earn decent income from high-quality bonds without reaching into riskier parts of fixed income or even equities for dividends. We favor income in these bonds but don't think they'll play the ballast role of the past in portfolios. Policy rates used to fall quickly as an economic downturn struck, pushing yields lower – but we think sticky inflation makes that unlikely. That's why we think long-term government bonds' ability to offset selloffs in risk assets will be less now: We don't see major central banks coming to the rescue of the economy with rate cuts this year. We see the Federal Reserve and European Central Bank hiking rates again this week even as growth takes a hit.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Bruno Rovelli
Chief Investment Strategist for Italy – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock **Investment** Institute

In the new macro regime of heightened growth and inflation volatility, we like bonds for income rather than earning returns from falling yields or using them as a portfolio ballast.

We're tactically overweight very short-term, high-quality government paper. Income is attractive, with limited credit and duration risk – or sensitivity to interest rate swings. Yet risks over raising the U.S. borrowing cap loom, with a deadline that could come sooner than initially expected as tax revenue comes in. We think a resolution will ultimately be reached. We see only a temporary rise in selected Treasury bill yields as the date nears when the U.S. Treasury might run into trouble making payments or need to prioritize debt payments over other obligations. Still, we could see market volatility and risk assets come under pressure as in past episodes. We remain modestly underweight U.S. stocks.

We think investment grade credit offers good income, with yields around 5% globally. We're tactically overweight European investment grade and prefer it to U.S. peers given more attractive valuations and its shorter duration. We put our new nimble playbook to work in March, cutting U.S. investment grade to neutral from overweight. We see less room for higher returns from tightening credit spreads but also see a decent amount of income with relatively limited risk compared with high yield. Still, we're monitoring the impact of tighter credit and financial conditions as higher interest rates hit economic growth and reverberate through the banking sector. We're also tactically overweight EM local currency debt on China's powerful economic restart, peaking interest rate hikes and a broadly weaker U.S. dollar.

Tactically, we prefer income from inflation-linked bonds over the dividend income provided by developed market (DM) equities. Equities can offer a sort of inflation protection if companies can pass on higher prices. But that depends on stocks reflecting the likely outlook for interest rates and growth – and we don't think DM stocks are pricing the damage from higher rates that we see ahead. That's a risk to dividends in the next 12 months – and the dividend yield of the S&P 500 is less than half of the 3.43% yield on the U.S. 10-year Treasury.

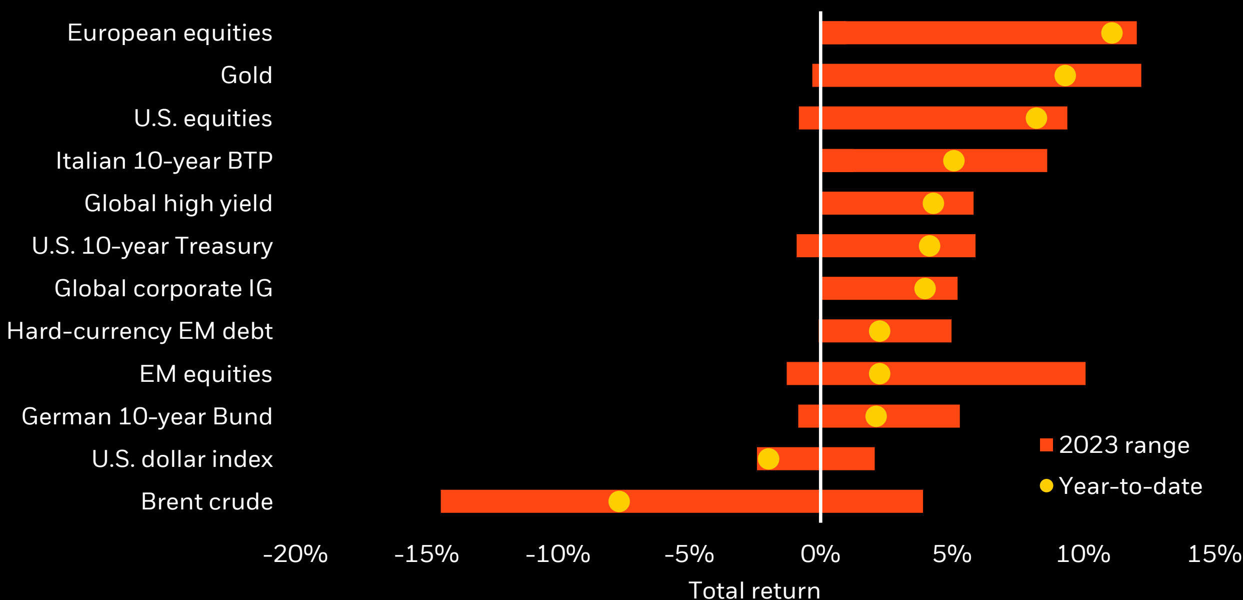
Bottom line: We see rates staying higher for longer in the new regime. That's why we favor bonds for income. We like very short-term, high-quality government paper, EM local currency debt and high-quality credit.

Market backdrop

U.S. stocks rallied from a four-week low last week after tech earnings beat expectations, helping offset renewed regional bank woes. The U.S. two-year Treasury yield fell back near 4.0% even as the market eyes a Fed rate hike this week. U.S. PCE data showed consumer spending losing momentum over the course of the first quarter. Strong U.S. wage growth pointed to inflation settling well above 2% policy targets – why we believe hopes for rate cuts this year are misplaced.

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 April 27, 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.

FOR PUBLIC DISTRIBUTION IN THE U.S., CANADA, LATIN AMERICA, HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

Macro take

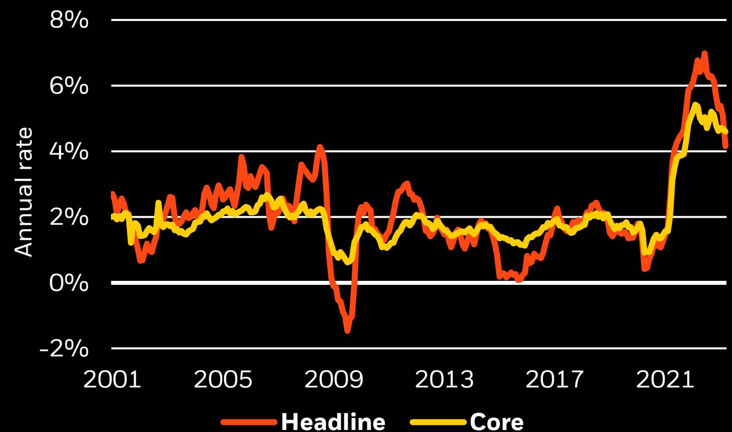
Momentum in consumer spending slowed through the first quarter after a strong January, according to last week's U.S. spending data. We expect spending to drop in coming months as households run out of pandemic savings. Annual headline inflation cooled to 4.2% but annual core inflation remains high at 4.6%, as core services inflation eased but core goods inflation returned. See the chart. The Employment Cost Index release showed annual wage growth running at nearly 5%. If that pace continues, services inflation will stay sticky and overall inflation will stay well above the Fed's 2% target.

This highlights the difficult trade-off the Federal Reserve continues to face: With inflation this persistent, the only way to get it back near 2% is by generating a recession. And it's why the Fed is willing to tolerate economic damage and financial cracks like we've seen recently in the U.S. banking sector. We still believe market hopes for rate cuts this year are misplaced, given the persistence of inflation.

Explore our recent Macro take blog posts here.

Inflation persists above policy targets

U.S. PCE inflation, 2001-2023



Source: BlackRock Investment Institute, Bureau of Economic Analysis, with data from Haver Analytics, April 2023. Notes: The orange line shows annual headline PCE inflation and the yellow line shows annual PCE inflation for all items excluding food and energy.

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. We think the Federal Reserve will halt rate hikes once the economic damage becomes clear. 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 very short-term government paper 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.

FOR PUBLIC DISTRIBUTION IN THE U.S., CANADA, LATIN AMERICA, HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

Week ahead

May 2	Euro area inflation and bank lending; U.S. job openings	**May 4**	European Central Bank (ECB) policy decision
May 3	Fed policy decision; U.S. ISM services PMI	**May 5**	U.S. payrolls; China Caixin services PMI

This week's focus will be on the Fed and ECB policy rate decisions. We think they'll hike interest rates again – and we don't see major central banks coming to the rescue with rate cuts this year as inflation remains sticky. We're also watching U.S. jobs data where we expect to see ongoing labor market tightness. That is keeping wage growth and core inflation elevated.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 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	+1	Neutral	Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. 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 remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are 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	-1	—	We're underweight private growth assets and neutral on private credit from a starting allocation that is much larger than what most qualified investors hold. 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.

FOR PUBLIC DISTRIBUTION IN THE U.S., CANADA, LATIN AMERICA, HONG KONG, SINGAPORE AND AUSTRALIA. FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 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 very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
	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	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. 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.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on macroeconomics, sustainable investing, geopolitics and portfolio construction to help Blackrock's portfolio managers and clients navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive and no representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. The opinions expressed are as of May 1, 2023 and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.

In the **U.S. and Canada**, this material is intended for public distribution. **In the European Economic Area (EEA)**: this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded. **In the UK and Non-European Economic Area (EEA) countries**: this is Issued by BlackRock Advisors (UK) Limited, which is authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL, Tel: +44 (0)20 7743 3000. Registered in England and Wales No. 00796793. For your protection, calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock. **In Italy,** for information on investor rights and how to raise complaints please go to https://www.blackrock.com/corporate/compliance/investor-right available in Italian. **For qualified investors in Switzerland:** This document is marketing material. This document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA"). For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: www.blackrock.com/finsa. **For investors in Israel:** BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. **In South Africa**, please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. **In the DIFC** this material can be distributed in and from the Dubai International Financial Centre (DIFC) by BlackRock Advisors (UK) Limited — Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it. Blackrock Advisors (UK) Limited - Dubai Branch is a DIFC Foreign Recognised Company registered with the DIFC Registrar of Companies (DIFC Registered Number 546), with its office at Unit 06/07, Level 1, Al Fattan Currency House, DIFC, PO Box 506661, Dubai, UAE, and is regulated by the DFSA to engage in the regulated activities of 'Advising on Financial Products' and 'Arranging Deals in Investments' in or from the DIFC, both of which are limited to units in a collective investment fund (DFSA Reference Number F000738) **In the Kingdom of Saudi Arabia,** issued in the Kingdom of Saudi Arabia (KSA) by BlackRock Saudi Arabia (BSA), authorised and regulated by the Capital Market Authority (CMA), License No. 18-192-30. Registered under the laws of KSA. Registered office: 29th floor, Olaya Towers – Tower B, 3074 Prince Mohammed bin Abdulaziz St., Olaya District, Riyadh 12213 – 8022, KSA, Tel: +966 11 838 3600. The information contained within is intended strictly for Sophisticated Investors as defined in the CMA Implementing Regulations. Neither the CMA or any other authority or regulator located in KSA has approved this information. The information contained within, does not constitute and should not be construed as an offer of, invitation or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. Any distribution, by whatever means, of the information within and related material to persons other than those referred to above is strictly prohibited. **In the United Arab Emirates** is only intended for - natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. **In the State of Kuwait**, those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. **In the Sultanate of Oman,** to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. In **Qatar**, for distribution with pre-selected institutional investors or high net worth investors. **In the Kingdom of Bahrain**, to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. The information contained in this document, does not constitute and should not be construed as an offer of, invitation, inducement or proposal to make an offer for, recommendation to apply for or an opinion or guidance on a financial product, service and/or strategy. **In Singapore**, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N). This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. **In Hong Kong**, this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. **In South Korea**, this material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations). **In Taiwan**, independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In Japan**, this is issued by BlackRock Japan. Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) For Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In Australia**, issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975 AFSL 230 523 (BIMAL). The material provides general information only and does not take into account your individual objectives, financial situation, needs or circumstances. **In China**, this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, excluding Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. **For Other APAC Countries**, this material is issued for Institutional Investors only (or professional/sophisticated /qualified investors, as such term may apply in local jurisdictions). **In Latin America**, no securities regulator within Latin America has confirmed the accuracy of any information contained herein. The provision of investment management and investment advisory services is a regulated activity in Mexico thus is subject to strict rules. For more information on the Investment Advisory Services offered by BlackRock Mexico please refer to the Investment Services Guide available at www.blackrock.com/mx

©2023 BlackRock, Inc. All Rights Reserved. **BLACKROCK** is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee