# Weekly commentary

BlackRock

March 21, 2022

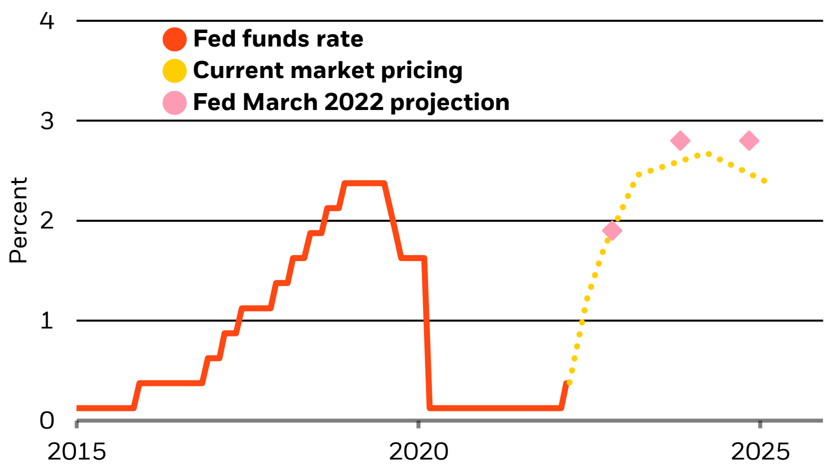
## Tough Fed talk on inflation, little bite

- The Fed is talking tough on inflation by projecting a large and rapid increase in rates, but we think it won't fully deliver and be forced to live with inflation.
- The S&P 500 scored its biggest weekly gain since 2020, and bond yields rose. Chinese shares rebounded sharply after officials reassured a panicky market.
- Economic data this week are likely to show a worsening in economic activity and consumer sentiment due to the Ukraine war and high inflation.

The Fed last week signaled a large and rapid increase in its policy rate over the next two years and struck a surprisingly hawkish tone, indicating it's ready to go beyond normalizing to try to tame inflation. It's easy to talk tough, and we believe the Fed is unlikely to fully deliver on its projected rate path. The reason? It would come at too high a cost to growth and employment. We do now see a higher risk of the Fed slamming the brakes on the economy as it may have talked itself into a corner.

### Unrealistically hawkish

U.S. federal funds rate, market pricing and Fed projections, 2015-2025




Sources: BlackRock Investment Institute, with data from Haver Analytics, March 2022. Notes: The chart shows the historical fed funds rate, current market pricing in forward overnight index swaps and the Fed's March 2022 projection based on the median dot of policymaker projections.

The Federal Reserve has kicked off its hiking cycle with a quarter-point increase – the first since 2018. The decision was expected. What surprised was the Fed's stated goal to get the fed funds rate to 2.8% by the end of 2023 (see the pink dots on the chart). This level is in the territory of destroying growth and employment, in our view. At the same time, the Fed's latest economic projections pencil in persistently high inflation but low unemployment – even as it has called current labor conditions tight. We believe this means the Fed either doesn't realize its rate path's cost to employment or – more likely – that it shows its true intention: to live with inflation. We think this is necessary to keep unemployment low because inflation is primarily driven by supply constraints and high commodities prices.

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The Bank of England (BoE), the first major developed market (DM) bank to kick off the current hiking cycle, increased its policy rate for the third time to 0.75%. Like the Fed, the BoE recognized additional inflation pressures from high energy and commodity prices. It also signaled that it may pause further rate increases, with rates back at pre-pandemic levels. We believe this means the BoE is willing to live with energy-driven inflation, recognizing that it's very costly to bring it down.

The BoE provides a glimpse of what other DM central banks may do once they get back to pre-pandemic rate levels and the effect of rate rises on growth become apparent. The Fed's tone may change as the consequences for growth become more apparent after aggressively hiking this year. The Fed last week perhaps wanted to appear tough by implying even more rate increases in future years to keep inflation expectations anchored, in our view, without expecting to deliver those hikes. To be sure: The Fed *will* normalize policy because the economy no longer needs pandemic-induced stimulus. It has also signaled it will start reducing its balance sheet, marking the start of quantitative tightening. Finally, we expect the Fed to raise the fed funds rate to around 2% this year – close to pre-pandemic neutral levels – and then pause to evaluate the effects.

What are the risks? Central banks are in a tough spot. First, they may start to believe some of their own rhetoric – and think they can raise rates well above neutral levels without damaging growth. They could hike too much, too fast as a result – and plunge economies into recession. We think this risk has risen since last week's Fed meeting. Second, inflation expectations could de-anchor and spiral upward as markets and consumers lose faith that central banks can keep a lid on prices. This could force them to act aggressively amid persistently high inflation.

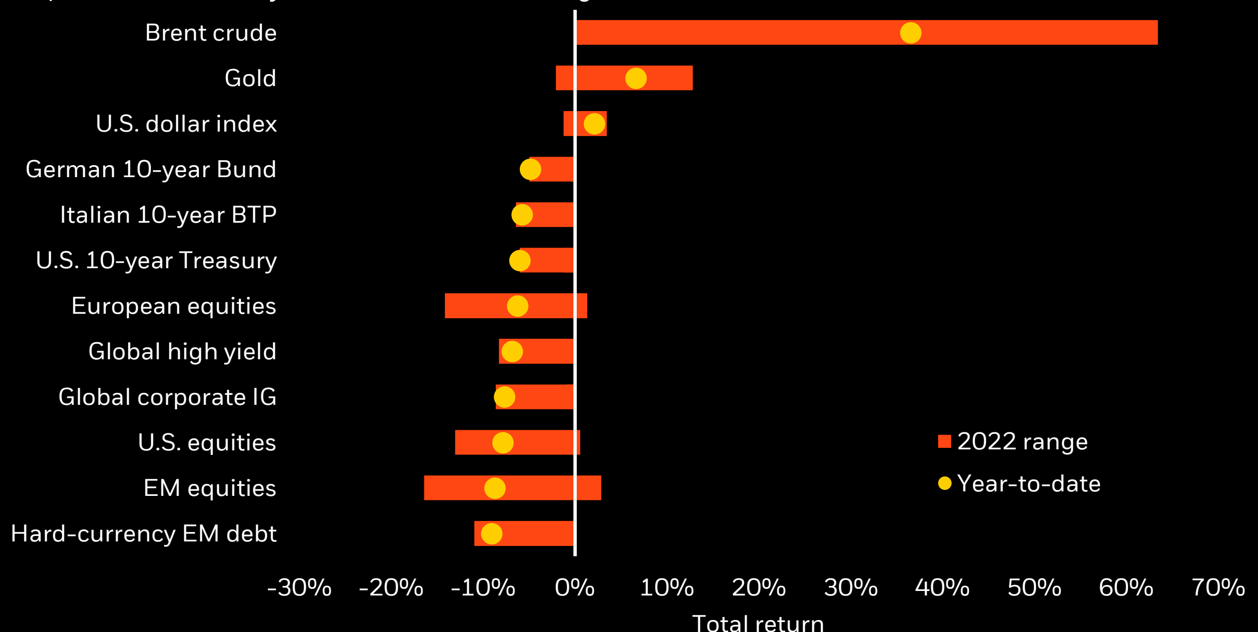
Our bottom line: Last week's central bank actions reinforce our views. We see more pain ahead for long-term government bonds even with the yield jump since the start of the year. We expect investors will demand more compensation for the risk of holding government bonds amid higher inflation. We stick with our underweight to nominal government bonds on both tactical and strategic horizons. We think the hawkish repricing in short-term rates is overdone and prefer short-maturity bonds over long-term ones. We prefer to take risk in equities over credit in the inflationary backdrop because we expect real – or inflation-adjusted – yields to stay historically low. We added to the DM equity overweight two weeks ago. We still like the overweight in this environment but see a differentiated regional impact from higher energy prices.

# Market backdrop

Stocks rallied and government bond yields climbed last week after the Fed raised rates and Chinese policymakers soothed beaten-down Chinese markets. Chinese equities rebounded after officials suggested an end to the crackdown on tech companies and announced a relaxation of Covid restrictions to hit growth targets. We believe China's ties to Russia have created a risk of geopolitical stigma, including potential sanctions.

## 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 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.

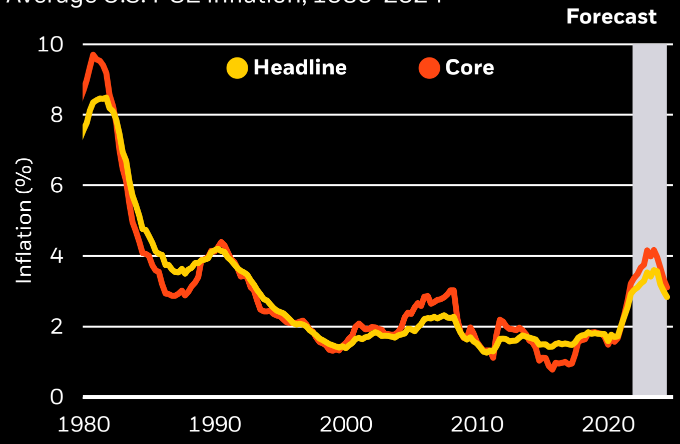
## Macro insights

We think central banks will ultimately live with the current supply-driven inflation. This inflation is caused by resource reallocations between sectors, such as the sharp shift in spending between goods and services since the pandemic hit. Academic research shows that policy achieves better outcomes by accommodating these reallocations.

The problem: The spike in energy prices in the wake of the Ukraine war adds a textbook supply shock on top of the restart-driven supply constraints already fueling inflation. Inflation is likely to stay higher for longer. As a result, we see a rising risk of inflation expectations becoming de-anchored from the Fed's 2% target as households and businesses see high inflation as the new normal and change their behaviors accordingly. The chart shows how three-year average inflation in the U.S. is well above the Fed's target and only expected to start turning lower in 2023. This raises the risk that inflation expectations become de-anchored – and central banks are forced to jack up rates and destroy activity to reset expectations. See our macro insights.

## Risk of de-anchoring

Average U.S. PCE inflation, 1980-2024




Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, Bloomberg, Federal Reserve Board, with data from Haver Analytics, March 2022. Notes: chart shows the three-year average annualized inflation rates for headline U.S. PCE inflation (yellow) and core PCE inflation (orange). Future values are derived from Bloomberg consensus forecasts up to Q3 2022 and beyond that from the Fed's own projections as of March 2022.

# 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 it raised rates for the first time since the pandemic. It projected higher-than-expected policy rates over the next two years and struck an unrealistically hawkish tone.
- It's easy to talk tough, and we believe the Fed is unlikely to deliver on the rate hikes. Markets for now agree, with U.S. two-year Treasury yields well below the Fed's projection for policy rates by the end of 2023.
- 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 cumulative response to rising inflation will be historically muted. 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.

# Week ahead

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|---|---|---|---|
| **March 22** | Hungary monetary policy meeting | **March 24** | Euro area, UK and U.S. flash PMIs |
| **March 23** | UK inflation | **March 25** | U.S. University of Michigan sentiment |

Early survey data for March are likely to show a sharp worsening in sentiment because of the war in Ukraine and a spike in energy and other prices. We see the war weighing heavily on economic activity – especially in Europe – and pushing up inflation as higher energy prices pass through to consumer prices. We underweight nominal government bonds and prefer developed stocks in this inflationary backdrop.

# 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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