

Weekly commentary

May 16, 2022



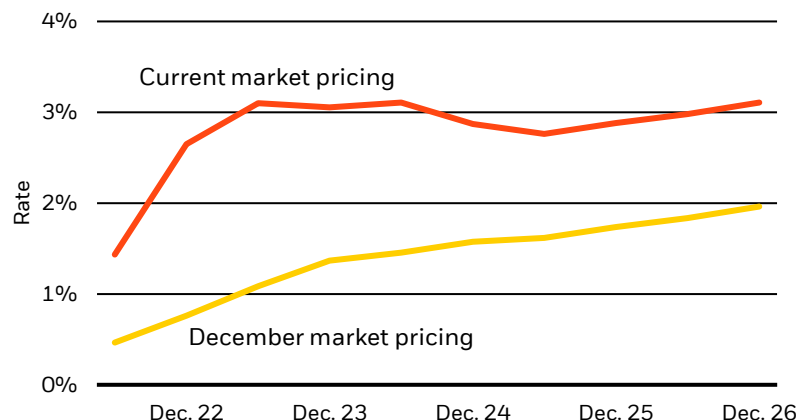
Why we still prefer stocks over bonds

- We recently cut risk, but stick with stocks over bonds for now. Equity prices now reflect much of the worsening macro outlook and hawkish Fed, in our view.
- Markets came to grips last week with the trade-off central banks face: choke off growth or live with inflation. Yields fell and stocks bounced off new 2022 lows.
- U.S. retail sales and other activity data will give investors a read on growth momentum. We believe the restart from pandemic lockdowns has room to run.

Equities have fallen hard this year on the prospect of rapid rate increases to rein in inflation, the tragic Ukraine war and a slowdown in China. We recently reduced risk, yet keep our modest stocks overweight. Why? The selloff means more of these risks are now priced. We also believe the Fed's sum total of rate hikes will be historically low and see recession fears as overblown. We think equities remain more attractive than bonds, even as the historic sell-off in bonds has cut the gap between the two.

Caution: steep rate path ahead

Market pricing of the fed funds rate, Dec. 2021 vs. current



Sources: BlackRock Investment Institute, with data from Bloomberg, May 2022. Notes: The chart shows expectations for the path of U.S. short-term interest rates based on futures market prices compared to the market's December expectations of the rate path.

We started the year with an overweight in equities and underweight in bonds. The macro outlook has worsened since then. The Ukraine war added to already high inflation stemming from pandemic-related supply constraints. The Fed started to talk tough on inflation, and the market has quickly priced in a series of steep rate rises (the red line in the chart), whereas it was still expecting a shallow trajectory in December (the yellow line). And we now see a rising risk the Fed will raise policy rates to a level that slows the economy. The latest: Growth in China has slowed amid widespread Covid lockdowns. Both stocks and bonds have sold off in the face of these mounting challenges. We stick with our equities overweight for now. Why? First, much of the risks to growth are now reflected in stock prices, we believe, keeping valuations attractive. Second, we still think the cumulative total of Fed rate hikes will be historically low, given the level of inflation. We see the Fed ultimately choosing to live with core inflation that's a bit higher than its 2% target, rather than fight it because of the costs to growth and jobs.



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The worsening economic outlook has prompted us to reduce portfolio risk this year. We downgraded European equities in March on the energy shock. We followed with a downgrade of Asian assets last week, coupled with an upgrade of investment grade credit and European government bonds. The sell-off in the bond market has narrowed the gap between the stocks and bonds, in our view, and created pockets of value. We still see longer-term yields rising further as investors demand a higher term premium, or compensation for the risk of holding government bonds amid high inflation and debt loads. As a result, we are not changing our overall bonds underweight and maintain our relative preference for equities.

What are the risks? Today’s inflation is very different from the past 30 years, and central banks need a new playbook. Inflation is always caused by excess demand over a certain amount of supply. That doesn’t mean excessive demand is driving inflation, as has been mostly the case since the 1990s. The real question: Is demand *unusually* high or is supply *abnormally* low? We think it’s the latter. The economy is working its way through two major shocks: the pandemic and the war in Ukraine. This has created supply constraints such as a tight labor market (caused by the “Great resignation”) that will take time to resolve. Why does all of this matter? If inflation is caused by supply factors, the Fed faces a stark choice: choke off growth with higher rates – the old playbook – or live with more persistent inflation. The risk is that the Fed fails to recognize the trade-off and pushes rates to such levels they destroy growth and jobs.

Markets are waking up to the risks surrounding this trade-off, and now look to be pricing in a fed funds rate of close to 3.5% in the very long run. If that’s true, equities may have more room to fall: Higher discount rates make future cash flows less attractive. We think the Fed ultimately won’t go this high for fear of hurting growth, but recognize hawkish policy pronouncements can lead markets to believe differently. This is why we brace for more volatility in the short run – and why we are not adding to our equities overweight despite improved valuations.

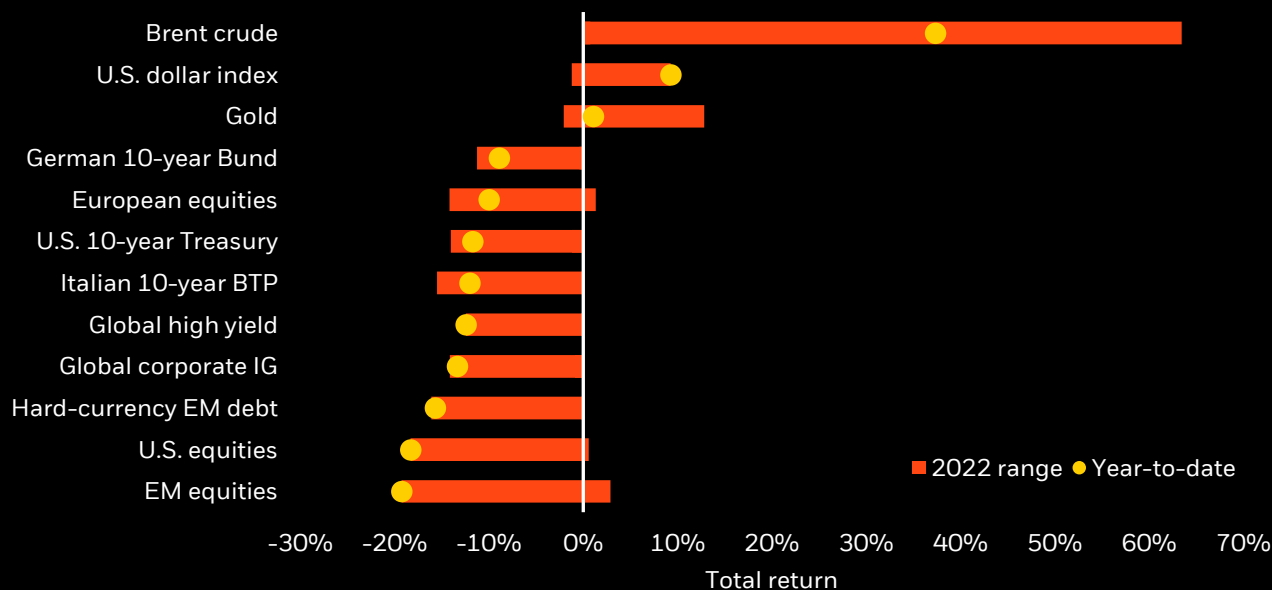
Our bottom line: We stay overweight equities and underweight bonds, but have reduced risk to reflect the worsening macro outlook. The momentum of the restart of economic activity is still strong, especially in the U.S., so we don’t see a recession ahead. We prefer developed market stocks, especially U.S. and Japanese equities. We particularly like the U.S. market’s quality bent featuring companies with strong cashflows and balance sheets. We would turn more negative on equities should the risk of the Fed slamming the brakes on the economy materialize and trigger a material slowdown.

Market backdrop

Markets are coming to grips with the stark growth-inflation trade-off central banks are facing to rein in supply-driven inflation: choke off growth or live with higher inflation. Last week, markets started to price in the risk that the Fed will push ahead with the first option. Yields on 10-year U.S. Treasuries fell, and stocks bounced off new 2022 lows. We believe the sharp trade-off will ultimately give the Fed pause before taking rates up to levels that trigger a material slowdown.

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 May 12, 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.

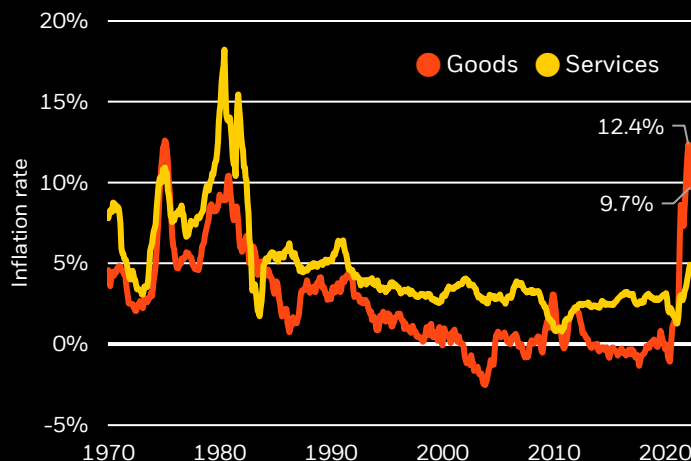
Macro insights

The U.S. economy is still restarting from the pandemic shutdowns, we believe. Look no further than the higher-than expected inflation data for April released last week. High inflation is largely due to the massive pandemic-induced shift in consumer spending toward goods and away from services, in our view. That shift pushed up goods prices as supply couldn't keep up with demand. Spending patterns need to normalize – or resources be fully reallocated – for inflation to drop off meaningfully. That's likely to take time, but we're seeing signs it's starting. The increase in goods prices is slowing (see orange line on the chart), while services prices are now rising more quickly (yellow line).

We don't think inflation will fall all the way back down to the Fed's target of 2% on its own accord, even as the restart completes. We believe we're in a higher inflation regime. We see core inflation settling closer to 3% because of longer-term supply constraints. Hiking policy rates enough to squeeze out that extra bit of inflation risk hitting growth and jobs hard. We think the Fed will rather live with slightly higher inflation. See our [macro insights hub](#).

Red-hot goods inflation slows

U.S. core goods and core services CPI inflation, 1970-2022



Sources: BlackRock Investment Institute and U.S. Bureau of Labor Statistics, with data from Haver Analytics, May 2022. Notes: The chart shows U.S. annual core goods and services CPI inflation.

Investment themes

1 Living with inflation

- Central banks are facing a growth-inflation trade-off. If they hike interest rates too much, they risk triggering a recession. If they tighten not enough, the risk becomes runaway inflation. It's tough to see a perfect outcome.
- The Fed has projected a large and rapid increase in rates over the next two years, and raised rates by 0.5% in May - the largest increase since 2000. We see the Fed delivering on its projected rate path this year but then pausing 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.
- The Bank of England of England warned of the poisonous combination of recession and high inflation as it raised interest rates to their highest level since 2009.
- The European Central Bank has also struck a hawkish tone, but we expect it to adopt a flexible stance in practice given the material hit to growth we see from higher energy prices.
- We believe the eventual sum total of rate hikes will be historically low, given the level of inflation.
- **Investment implication:** We prefer equities over fixed income and 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 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.
- We see a worsening macro outlook because of the commodities price shock and a growth slowdown in China.
- **Investment implication:** We have slightly reduced our risk exposure.

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 energy 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

May 17

U.S. retail sales and industrial production; Japan GDP

May 19

U.S. Philly Fed Business Index; Japan CPI; UK retail sales

May 18

UK CPI; Japan trade data

U.S. activity data and surveys will shed light on the ongoing restart of economic activity and the shift in consumer spending back to services, from goods. Market concerns around a pronounced slowdown in the U.S. miss the key point that the restart has further room to play out, in our view.

Directional views







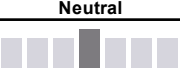




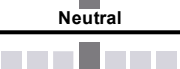
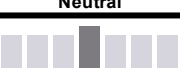



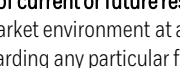

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, May 2022

Asset	Strategic view	Tactical view
Equities	<p>+2</p>	<p>+1</p> <p>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.</p>
Credit	<p>-1</p>	<p>Neutral</p> <p>We are underweight credit on a strategic basis against a backdrop of rising interest rates. We prefer to take risk in equities instead. Tactically, we had upgraded credit to neutral as the dramatic sell-off this year restored value in areas such as investment grade. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk, in our view.</p>
Govt bonds	<p>-1</p>	<p>-1</p> <p>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.</p>
Private markets	<p>Neutral</p>	<p>Neutral</p> <p>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.</p>

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, May 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 are moderately overweight 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 are overweight Japan equities on supportive monetary and fiscal policies - and the prospect of higher dividends and share buybacks.	
China	 Neutral	We recently downgraded Chinese equities to neutral on a worsening macro outlook. China's ties to Russia also have created a new geopolitical concern that requires more compensation for holding Chinese assets, we think.	
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. China's deteriorating macro outlook is a worry, and policymakers have yet to fully deliver on promises of easing.	
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	 Neutral	We are neutral European government bonds. Market pricing of euro area rate hikes is too hawkish, we think, given the energy shock's hit to growth.	
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	 Neutral	We are neutral Chinese government bonds. Policymakers have yet to take easing actions to avoid a slowdown, and yields have fallen below U.S. Treasuries.	
Global investment grade	 Neutral	We are neutral investment grade credit as this year's sell-off has made valuations more attractive. Coupon income is the highest in about a decade.	
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	 Neutral	We are neutral Asia fixed income. A worsening macro outlook and geopolitical concern about China's Russia ties make Chinese assets riskier, in our view. Outside China, we like Asian sovereigns and credit for income.	

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