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Weekly commentary

BlackRock.

August 8, 2022

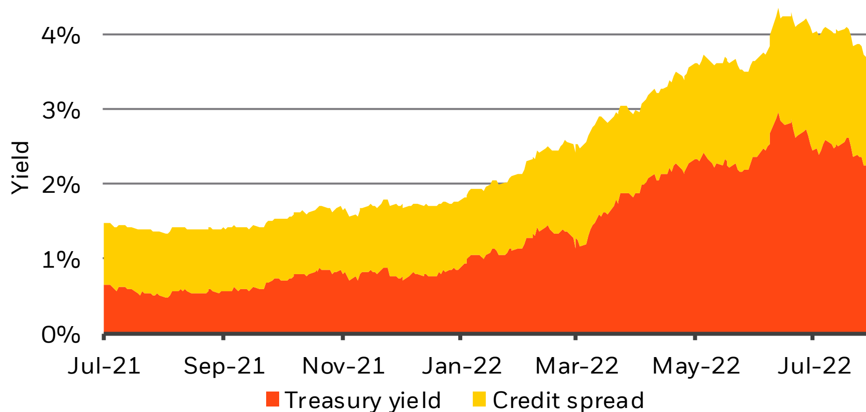
Why we like credit over equities

- We prefer investment grade credit over equities right now. Our reasoning: valuations, strong balance sheets, low supply and moderate refinancing risks.
- U.S. data last week showed strong job creation but still low labor participation. Stocks lost steam and bond yields spiked as markets priced in more Fed hikes.
- We expect U.S. CPI and PPI data this week to show that high inflation is persisting. China's social financing and CPI inflation data are also in focus.

We prefer investment grade (IG) credit over equities on a tactical horizon as we see a new market regime with higher volatility taking shape. First, yields on IG credit have risen, making for improved valuations and a larger cushion against defaults. Second, balance sheets are strong, we think. Third, supply is low, and we see only moderate refinancing risks. Our conclusion: We believe IG credit can weather a significant growth slowdown whereas equities don't look priced for this risk.

Attractive yields

U.S. Treasury yield and IG credit spread, July 2021–July 2022



Sources: BlackRock Investment Institute, with data from Bloomberg, July 2022. Notes: The yellow stacked area shows investment grade (IG) credit option-adjusted spread of the Bloomberg Global Aggregate Credit Total Return Index Value Unhedged in U.S. dollars over U.S. Treasuries in percentage points. The red area shows the yield of U.S. Treasuries as a portion of the overall index yield.

Yields look more attractive than at the start of the year, in our view. That's because of a surge in government bond yields (red area in chart) and a widening of spreads (yellow area), the risk premium investors pay to hold IG bonds over government peers. Since June, markets have been captivated by the prospect of lower rates in the face of a growth slowdown. This has resulted in a drop in yields, boosting IG performance and triggering a 10%-plus equities rally. We still like IG credit at these levels. Spreads have only marginally narrowed as investors lean back into equities. Plus, we think higher coupon income provides a cushion against another yield spike as markets price in the persistent inflation we expect. Equity valuations, meanwhile, don't reflect the chance of a significant slowdown yet, so earnings estimates are still optimistic, in our view.

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IG companies are in good shape, in our view. First, debt servicing remains low by historical standards and leverage has been coming down. U.S. non-financial IG companies lowered leverage, as measured by debt-to-equity, for the seventh straight quarter at the end of last year, according to ratings agency S&P Global. Second, the number of defaults in 2022 is the lowest since 2014, S&P data show. Lastly, we think credit quality is still solid. S&P's tally shows that rising stars in credit, or those that gain into investment grade status from high yield, have outpaced those going the other way, so-called fallen angels. We are neutral high yield as we prefer up-in-quality credit amid a worsening macro backdrop. We think parts of high yield offer attractive income, but concern over widening spreads in any slowdown steers us toward IG.

Trends in the corporate bond market also support our overweight on credit, in our view. First, supply is relatively low. Corporate bond issuance is down almost 20% this year versus 2021, according to S&P. Many issuers could be waiting to see if financing conditions improve before issuing more debt. Second, refinancing needs don't look pressing after a surge in issuance last year. For example, typical U.S. IG bond issuance of around $1 trillion a year easily exceeds upcoming maturities of less than $600 billion a year through 2029, S&P data show.

How do inflation and the Fed's next moves play into our credit view? Markets currently appear to expect that a mild contraction will result in falling rates and lower inflation. We don't think such a "soft landing" is likely in a volatile macro regime shaped by production constraints. Central banks will have to plunge the economy into a deep recession if they really want to squash today's inflation – or live with more inflation. We think they'll ultimately do the latter – but they are not ready to pivot yet. As a result, we see lower growth *and* elevated inflation ahead. We see bond yields going up and equities at risk of swooning again. IG credit, in our view, benefits from relatively high all-in yields that reflect moderate default probabilities.

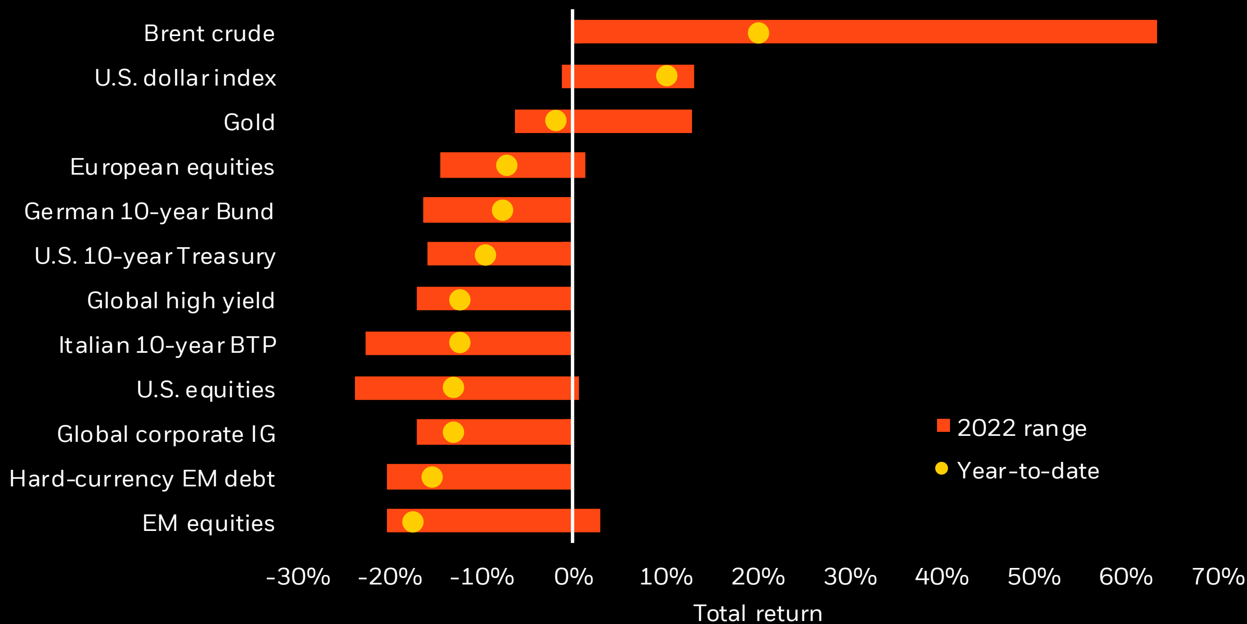
What's our bottom line? We overweight IG credit versus equities on a tactical horizon. This is a move up in quality in a whole portfolio approach after we reduced risk throughout this year in response to higher macro volatility. IG valuations still look attractive, balance sheets appear strong, refinancing risks seem moderate. As a result, we see IG credit weathering a slowdown better than stocks. We see activity stalling, underpinning our underweight to most developed market equities. Rising input costs also pose a risk to elevated corporate profit margins. When would we turn positive on equities again? Our signpost is a dovish pivot by central banks when faced with a big growth slowdown, a definite sign they will live with inflation.

Market backdrop

The U.S. economy added some 528,000 new jobs in July, double the average of analyst expectations. The labor market has not yet normalized, with labor force participation ticking down, while wages ticked up. This caused the rally in U.S. stocks to lose steam and bond yields to spike as markets priced in higher odds of a 0.75%-hike by the Federal Reserve in September. This aligns with our view that markets had prematurely priced in a dovish pivot by central banks amid signs of a 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 Aug. 4, 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.

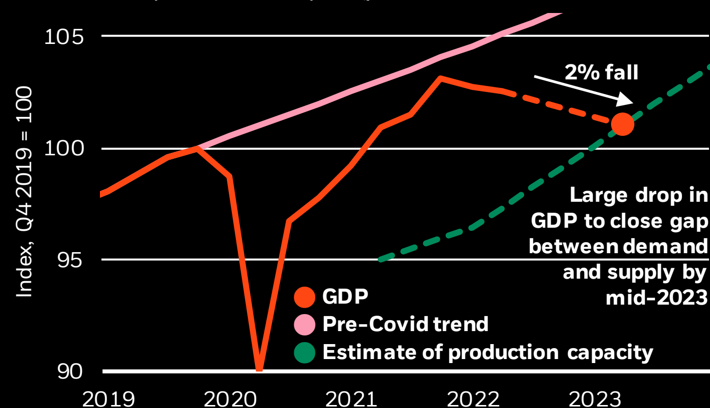
Macro take

Inflation will only retreat to normal levels when demand and production capacity are in balance. In our latest Macro Take, Alex Brazier and Nicholas Fawcett explain why production capacity – dealt a heavy blow by the pandemic – is not likely to fully recover any time soon.

That puts central banks in a bind: They don't have the tools to increase production capacity. The only way they can get inflation down quickly is by raising rates high enough to force demand down towards what the economy can comfortably produce now. It takes time for rate hikes to take effect. So if the Fed wanted to get U.S. inflation back to its 2% target within two years, that would require rate rises that cause GDP to fall by a little over 2% in total. See the chart. That's 1.5% on top of the estimated 0.6% fall already seen in the first half of this year. It could push the unemployment rate past 5% – meaning up to three million more people out of work. Is there an alternative? Let demand stay above the level the economy can comfortably support and live with higher inflation. Read the full piece here.

High cost of taming inflation

U.S. GDP and production capacity, 2017-2024



Sources: BlackRock Investment Institute and U.S. Bureau of Economic Analysis, with data from Haver Analytics, August 2022. Notes: The chart shows demand in the economy, measured by real GDP (in orange), and our projection of pre-Covid trend growth (in pink). The green dotted line shows our estimate of current production capacity. We infer that from how far core PCE inflation has exceeded the Federal Reserve's 2% inflation target.

Investment themes

1 Bracing for volatility

- The Great Moderation, a long period of steady growth and low inflation, has ended in our view. We see macro and market volatility reverberating through the new regime. What changed? Production constraints triggered by the pandemic and the war in Ukraine are pressuring the economy and inflation. We see this persisting amid powerful structural trends like global fragmentation and sectoral shakeouts tied to the net-zero transition.
- Unprecedented leverage gives policymakers less maneuvering room, in our view. And the politicization of everything makes simple solutions elusive when they're needed the most, we think. This leads to bad outcomes.
- We expect higher risk premia for both equities and bonds – so investment decisions and horizons must adapt more quickly. Traditional portfolios, hedges and risk models won't work anymore, we think.
- In the U.S., we expect volatile growth and persistent inflation. The upside risk is that production capacity normalizes faster. The downside is that the Fed fails to change course next year and slams demand down to meet low capacity.
- In Europe, we see recession as likely even absent big rate hikes as broad economic stress from an energy crisis bites.
- **Investment implication:** Be nimble. We're tactically overweight investment grade credit on attractive valuations.

2 Living with inflation

- We are in a new world shaped by supply. Major spending shifts and production constraints are driving inflation.
- Constraints are rooted in the pandemic and have been exacerbated by the war in Ukraine and China's lockdowns.
- The Fed increased rates by another 0.75% in July and reaffirmed projections of more rate rises with the aim to rein in inflation. The Fed is still looking through the lens of a typical late-cycle overheating as opposed to a restart, in our view. Reality will come knocking eventually, we think, and a stalled restart will prompt the Fed to change course.
- The Bank of England raised rates to 1.75% in August. It also acknowledged the growth-inflation trade-off – unlike other major central banks. It now sees a protracted recession through 2023, partly due to the energy shock.
- The ECB surprised with a larger-than-expected 0.5% rate rise in July. It also announced a new bond-buying facility to limit risks of higher rates causing the euro area to fragment. The ECB and markets underappreciate the risk of the energy crunch causing a recession, we think. The ECB will eventually accept this and rethink its rate path.
- **Investment implication**: We are tactically underweight most DM equities after having further trimmed risk.

3 Positioning for 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.
- We see a global drive for more energy security accelerating the transition in the medium term, especially in Europe.
- We also don't think the markets have fully priced in the transition yet. Over time, markets are likely to value assets of companies better prepared for the transition more highly relative to others, in our view.
- We think investors can get exposure to the transition by investing not only in "already green" companies but also in carbon intensive companies with credible transition plans or that supply materials critical to the transition.
- We like 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**: Time horizon is key. We see tactical opportunities in selected energy stocks.

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Week ahead

Aug. 10	U.S. and China CPI inflation data	**Aug. 12**	UK GDP; U.S. University of Michigan sentiment survey
Aug. 11	U.S. PPI data	**Aug. 10-17**	China total social financing

All eyes will be on this week's U.S. CPI and PPI data to gauge whether high inflation is persisting. We see inflation staying above the Fed's 2% target through next year. We think the Fed will keep responding to calls to tame inflation until it acknowledges how that would stall growth. We're also watching China's social financing and CPI inflation data releases.

Directional views

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

Underweight | Neutral | Overweight | ● Previous view

Asset	Strategic view	Tactical view	
Equities	+2	-1	We are overweight equities in our strategic views of five years or longer. We expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we are underweight DM equities as central banks appear set to overtighten policy and we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	-1	+1	We are underweight publicly traded credit on a strategic basis and prefer to take risk in equities. Tactically, we are overweight credit given the jump in yields and credit spreads – and our view of contained default risk. We overweight local-currency EM debt on attractive valuations and potential income. A large risk premium compensates investors for inflation risk.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds, with a preference for short-dated maturities. We stay firmly underweight long-dated bonds as we see investors demanding higher compensation amid rising inflation and debt levels. We prefer inflation-linked bonds instead. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022. We prefer inflation-linked bonds as portfolio diversifiers amid higher inflation.
Private markets	Neutral	—	We believe non-traditional return streams 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. We underweight private equity, favoring income assets such as private credit instead. Many institutional investors are 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, August 2022

Underweight | Neutral | Overweight | ● Previous view

Asset	View	Commentary
Developed markets	-1	We are underweight DM stocks on a worsening macro picture and risks to corporate profit margins from higher costs. Central banks appear set on reining in inflation by crushing growth – increasing the risk of the post-Covid restart being derailed.
United States	-1	We are underweight U.S. equities. The Fed intends to raise rates into restrictive territory. The year-to-date selloff partly reflects this. Yet valuations have not come down enough to reflect weaker earnings.
Europe	-1	We are underweight European equities as the fresh energy price shock in the aftermath of the tragic war in Ukraine puts the region at risk of stagflation.
UK	-1	We are underweight UK equities following their strong performance versus other DM markets thanks to energy sector exposure.
Japan	Neutral	We are neutral Japan stocks. We like still easy monetary policy and increasing dividend payouts. Slowing global growth is a risk.
China	Neutral	We are neutral Chinese equities. Activity is restarting, but we see 2022 growth below official targets. Geopolitical concerns around China's ties to Russia warrant higher risk premia, we think.
Emerging markets	Neutral	We are neutral EM equities on the back of slowing global growth. Within the asset classes, we lean toward commodity exporters over importers.
Asia ex-Japan	Neutral	We are neutral Asia ex-Japan equities. China's near-term cyclical rebound is a positive yet we don't see valuations compelling enough to turn overweight.
U.S. Treasuries	-1	We are underweight U.S. Treasuries even with the yield surge. We see long-term yields moving up further as investors demand a greater term premium. We prefer short-maturity bonds instead and expect a steepening of the yield curve.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. Markets are underappreciating the inflationary pressures from the energy shock, we think.
European government bonds	Neutral	We are neutral European government bonds. We think market pricing of euro area rate hikes is too hawkish.
UK gilts	+1	We are overweight UK gilts. Gilts are our preferred nominal government bonds. We believe market pricing of the Bank of England's rate hikes is unrealistically hawkish in light of deteriorating growth.
China government bonds	Neutral	We are neutral Chinese government bonds as policymakers have been slow to loosen policy to offset the slowdown, and they are less attractive than DM bonds.
Global investment grade	+1	We are overweight investment grade credit. High quality corporates' strong balance sheets imply IG credit could weather weaker growth better than stocks.
Global high yield	Neutral	We are neutral high yield. We prefer up-in-quality credit exposures amid a worsening macro backdrop. We think parts of high yield offer attractive income.
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 inflation risk.
Asia fixed income	Neutral	We are neutral Asia fixed income amid a worsening macro outlook. We don't find valuations compelling enough yet to turn more positive on the asset class.

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