Weekly commentary

October 3, 2022

BlackRock

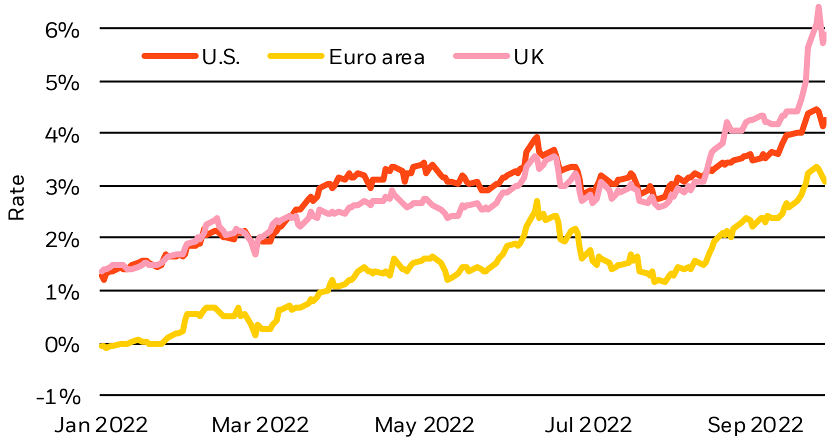
We keep risk low amid volatile macro

- The new regime poses an unavoidable trade-off for central banks: tame inflation by hiking or preserve growth. We see them overtightening rates so keep risk low.
- UK gilt yields reached 14-year highs before the Bank of England intervened to halt the selloff. Yields on 10-year U.S. treasuries topped 4%, a first since 2010.
- The U.S. jobs report will be a key gauge of whether labor force participation is increasing. ISM manufacturing data should give perspective on recession risks.

We've said a period of steady growth and inflation known as the Great Moderation is over – and made this central to our investment views. Central banks face a brutal trade-off in this new regime: either live with inflation or the economic damage needed to tame it quickly. There's no way around this, or no "soft landing," in our view. Case in point: the UK's fiscal splurge. It didn't push up growth expectations; it only resulted in higher rates. We stick with dialed-down risk.

UK rates surge as policy forces clash

Market pricing of future policy rates, 2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2022. Notes: the chart shows the pricing of expected central bank policy rates via forward overnight index swaps. The rate is the one-year OIS rate expected starting one year from now.

The trade-off central banks face in a regime of heightened macro volatility and a world shaped by production constraints came into sharper focus last week. Fiscal authorities in the UK tried to boost growth with unfunded tax cuts and spending increases. Markets shook. Rate expectations for the Bank of England surged above other major central banks (see pink line in chart). Growth expectations did not – the pound plummeted to all-time lows and stocks fell. This all shows how we are in a new regime, where authorities can't spend to avoid recession. We think getting inflation down quickly would take aggressive rate hikes and recession. Central banks are trying to do whatever it takes to tame inflation, but they haven't acknowledged what it will take, in our view. We expect them to break growth as a result, but then stop in 2023 once the economic damage is clear.

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The macro picture has worsened as a result. We expect recessions in major developed markets (DM). That could be next year in the U.S. but sooner and deeper in the euro area given the energy crunch. Central banks prioritizing the pressure to bring inflation down quickly over the economic implications implies deeper recessions overall, in our view.

This is why we stick with reduced risk taking in our tactical investment views. We're looking for the least bad options. We're underweight DM equities. Stocks have yet to fully price in recession fears and higher rates, in our view. We think earnings expectations also seem optimistic. An energy crisis further dampens our view of European stocks. Japan is different – still easy monetary policy keeps us neutral. Valuation remains an important signpost for us to consider getting more positive on stocks. Relatively attractive valuations are also why we prefer credit over stocks. Higher yields and strong balance sheets suggest to us investment grade credit is better placed than equities to weather recessions.

We're underweight DM bonds because we think inflation will persist above central bank targets after hiking stops. That said, we see some value in the shorter maturities because of the safety they provide as the closest cash-like investment. Persistent inflation also underpins our overweight on inflation-linked bonds. We're overweight emerging market (EM) debt. Central banks are well ahead of others in their cycles. EM currencies have also held up fairly well in the risk-off environment. But we remain wary of the currency outlook as some central banks in EM have paused their tightening as growth deteriorates.

Strategic positioning is shaped by our view that central banks will stop hiking next year and not go as far as necessary to get inflation back to target quickly. Recent events reinforce our conviction they will halt rate hikes and live with inflation once confronted with economic damage – either in the form of recession or cracks in financial stability, or both. This will be more favorable to equity than bonds – so we're overweight DM stocks. We prefer public to private equity. Inflation will persist, so we prefer inflation-linked bonds to nominal bonds. We're overweight public credit on attractive valuations and income potential.

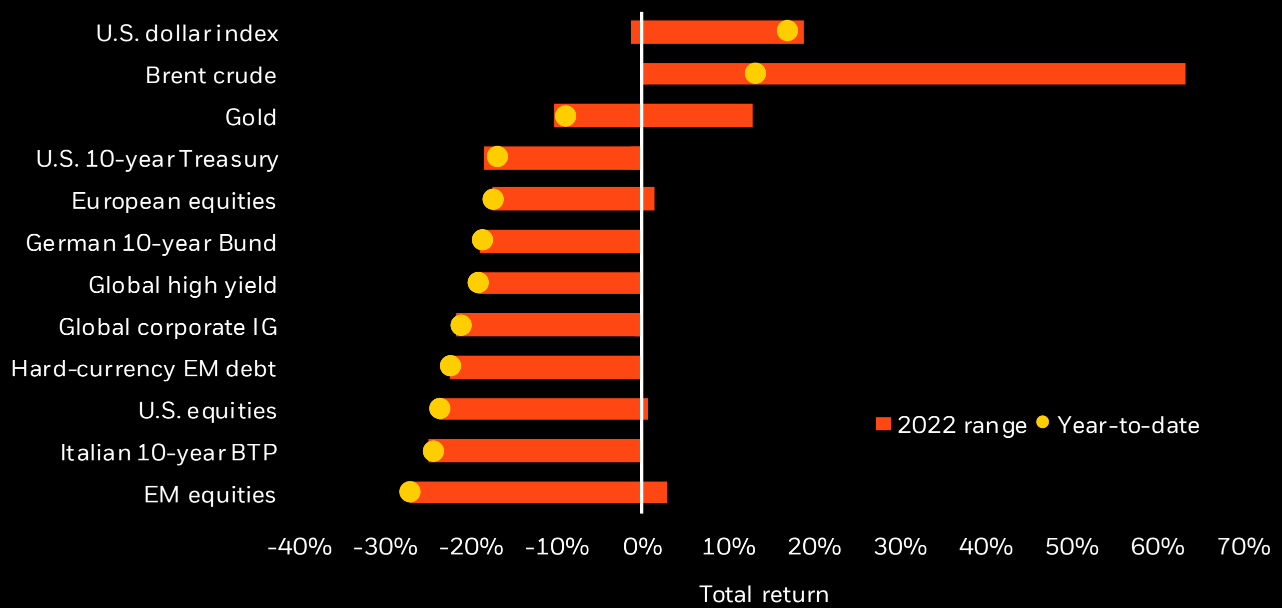
Our bottom line: We stick with reduced risk taking, tactically. Heightened macro volatility in a new regime creates stark trade-offs for central banks at risk of overtightening into recessions. Tactically, that means we prefer credit over stocks. Equities remain relatively attractive alongside credit longer term. Persistent inflation keeps us negative on nominal bonds and positive on inflation-linked bonds now and even more so further out into our strategic investment horizon.

Market backdrop

UK gilt yields eased from 14-year highs and the pound clawed back from all-time lows after the surprise government fiscal splurge forced the Bank of England to temporarily buy long-term bonds to stabilize yields. The events illustrate the sharp trade-off policymakers face on higher inflation – and the potential financial dislocations from higher rates. We see risks of central banks overtightening into recessions. U.S. 10-year Treasury yields briefly topped 4% and equities hit fresh lows.

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 Sept. 29, 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.

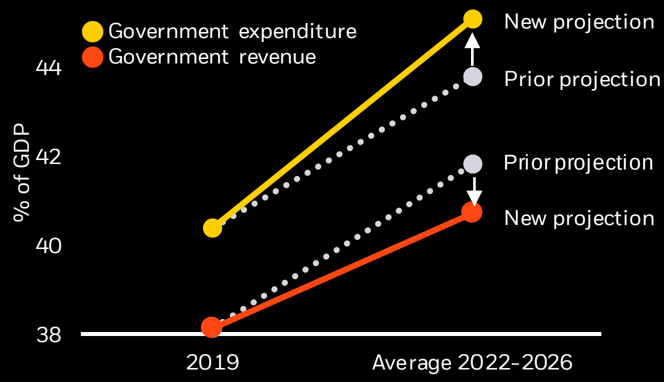
Macro take

Markets took fright at the UK government's recent "mini-budget." Why? Because the numbers don't add up. The government introduced tax cuts, despite having announced additional spending – in the form of energy bill subsidies – just a few weeks prior. That puts an even bigger gap between government revenue and spending. See the chart. Such a gap is not sustainable without either a rapid spell of economic growth or further borrowing. We estimate it would take a growth rate not seen since before the financial crisis - pretty optimistic. The only alternative is to borrow more.

Markets questioned the credibility of that plan, causing gilt yields (borrowing costs for the UK government) to soar to their highest level since 2008. Policies are clashing, as the government seeks to boost growth while the Bank of England (BoE) tries to squash growth to get inflation down quickly. We think that means the BoE is now likely to raise rates even further to offset those government measures. Watch out for this week's Macro take to find out what lessons that provides for other countries.

UK budget: the numbers don't add up

UK revenue and expenditure, 2019 and 2022-2026 projections



Source: BlackRock Investment Institute, UK Office for Budget Responsibility, HM Treasury, with data from Haver Analytics, September 2022. Notes: The chart shows government expenditure (yellow) and revenue (orange) as a share of GDP. The 2019 data show actual revenue and spending in the fiscal year 2019, and the projected average for 2022-26 is based on projections from the OBR (in gray) and the OBR combined with costings from the HM Treasury Plan for Growth, Sept. 23, 2022. This includes our own estimate of the projected cost of energy subsidies beyond the six-month costing period published by HM Treasury.

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:** We are 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 0.75% a third-straight time in September and revised higher its projections for rate rises with the aim to rein in inflation. We think this leaves the Fed with no room to back off its hiking intention – and now that can only happen after the Fed is surprised by the growth damage rate hikes will cause.
- After hiking rates again in September, the Bank of England (BoE) will likely have to hike more and leave rates higher for longer after the UK government revealed a fiscal splurge. The BoE's intervention in bond markets highlights how we're in a new regime of higher macro and market vol – and how sharp rate hikes can cause financial dislocations.
- The ECB announced a record 0.75% rate hike in September and cut its growth forecasts. The ECB's forecasts show it is still underappreciating the energy crunch's hit to growth, in our view. We expect the ECB to keep raising rates through this year but then stop once it sees the scale of economic damage caused by the energy crisis and hikes.
- **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.

Week ahead

Oct. 3	U.S. ISM manufacturing PMI	**Oct. 7**	U.S. payrolls report
Oct. 6	India services PMI	**Oct. 8**	China Caixin services PMI

The key release this week is the U.S. jobs report. A rapid pace of job gains has not disguised the fact that the overall level of labor supply remains low compared to pre-Covid – a key production constraint that's driving inflation higher, in our view. Survey data have softened over the past year. ISM manufacturing data should give more perspective on recession risk.

Directional views

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

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views. A higher risk premium and worsening macro backdrop lowers our expected equity returns. But we expect central banks to ultimately live with some inflation and look through the near-term risks. Tactically, we're underweight DM stocks as central banks look set to overtighten policy – we see activity stalling. Rising input costs also pose a risk to elevated corporate profit margins.
Credit	+1	+1	Strategically, we are overweight publicly traded credit – from high yield to global investment grade. Higher spreads and government bond yields push up expected returns, and we think default risk is contained. Additionally, income potential is attractive. Tactically, we're overweight investment grade but neutral high yield. We prefer to be up in quality. We overweight local-currency EM debt on attractive valuations. A large risk premium compensates investors for inflation risk, in our view.
Govt bonds	-1	-1	A modest underweight in our strategic view on government bonds reflects a big spread: max underweight nominal, max overweight inflation-linked and an underweight on Chinese bonds. We see nominal yields in five year's time higher than current levels. That repricing is a valuation drag on expected returns. We also think markets are underappreciating the persistence of high inflation. Tactically, we are also underweight as we see long-term yields going higher – even as yields have surged in 2022.
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.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, October 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 prospects.
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. Attractive carry spurs a preference for short-maturity bonds.
Global inflation-linked bonds	+1	We are overweight global inflation-linked bonds and prefer Europe. The pullback in euro area breakeven rates since May suggests markets are underappreciating the inflationary pressures from the energy shock.
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 underweight UK gilts after the fiscal splurge. We think the Bank of England will need to hike rates higher to rein in inflation. We see rising term premium driving yields higher at the long end.
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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