

# Weekly commentary

October 10, 2022

**BlackRock**

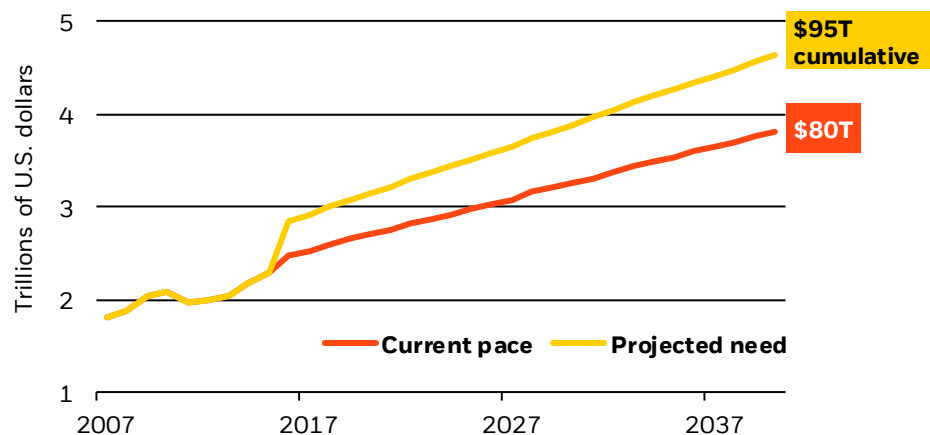
## Infrastructure: taking the long view

- Macro policy is ripping through markets now. We step back and look at why real assets in private markets like infrastructure could be attractive long term.
- Stocks fell after U.S. payroll gains slowed but not enough to deter the Fed from its singular focus on inflation, with a fourth 0.75% hike in November likely.
- We think an upside surprise to CPI inflation data this week could strengthen the Fed's resolve to keep hiking, but a downside surprise will not sway it to back off.

Rapid rate hikes are hitting markets now and will likely spark a recession, but we eventually see central banks stopping and living with inflation. This informs our long-term investment views. Private markets are long term by design – they're also complex and not suitable for all investors. Public market selloffs have cut the relative appeal of many private assets, but we see value in infrastructure thanks to a huge investment wave powered by the energy crunch and digitalization.

## Investment gap

Infrastructure investment, 2007-2040



Sources: BlackRock Investment Institute and World Bank, 2017. Notes: The chart shows estimated infrastructure investment for 50 countries through 2040. The yellow line shows investment needed annually. The orange lines show investment trends assuming countries invest in line with current trends. The cumulative total of \$95 trillion is for investment needed vs. \$80 trillion in current trends. Forward looking estimates may not come to pass.

What makes infrastructure special? For one, elements of it can be seen all around. From roads to airports and energy infrastructure, these assets are essential to industry and households alike. Future needs also appear to be rising at a rapid pace. Infrastructure has the potential to benefit from increased demand for capital over the long term. An estimated \$95 trillion of cumulative investment could be needed to meet global infrastructure demand over the next two decades, World Bank data show (see the yellow line in chart). That's compared to the estimated current pace of around \$80 trillion (red line), implying a total investment gap of about \$15 trillion. We also find infrastructure valuations have been steadier than other private markets like real estate and private equity – they haven't increased as much in the falling rate environment of the last few decades.



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Structural trends could also support infrastructure. We find that the net-zero transition isn't fully priced by markets across many asset classes. We think infrastructure has potential to capture the expected shift to sustainable assets. In the U.S., the Inflation Reduction Act alone earmarks nearly \$400 billion of investment and incentives in sustainable infrastructure and supply chains – and the potential to pull in private investment goes well beyond the headline figures. That means there could be opportunity for private investors to get exposure at favorable financing costs. Other trends like digitalization and decentralization signal potential for greater demand. More infrastructure would be needed to allow for the future of work. As location becomes less important, holdings would need to diversify for resilience and efficiency.

We believe that infrastructure stands out with the potential to diversify returns and help provide stable long-term cashflows. Why? Infrastructure earnings are less tied to economic cycles than corporate assets. Long-term contracts are common. Contracts can span decades – a significant advantage in a volatile environment, in our view. Infrastructure assets also have the potential to hedge some of the effects of inflation. Most power and utility assets link their costs and prices to inflation through regulations, concession agreements or contracts. That allows them to pass higher expenses through to end users. We see risks. The new regime of increased macro and market volatility hangs over all markets, including private markets – they're not immune to rising interest rates. Key production constraints like labor could take longer to normalize, and interest rates could remain higher than historical norms. Both would raise costs. More specifically to infrastructure, governments could also impose artificial price caps amid political pressure.

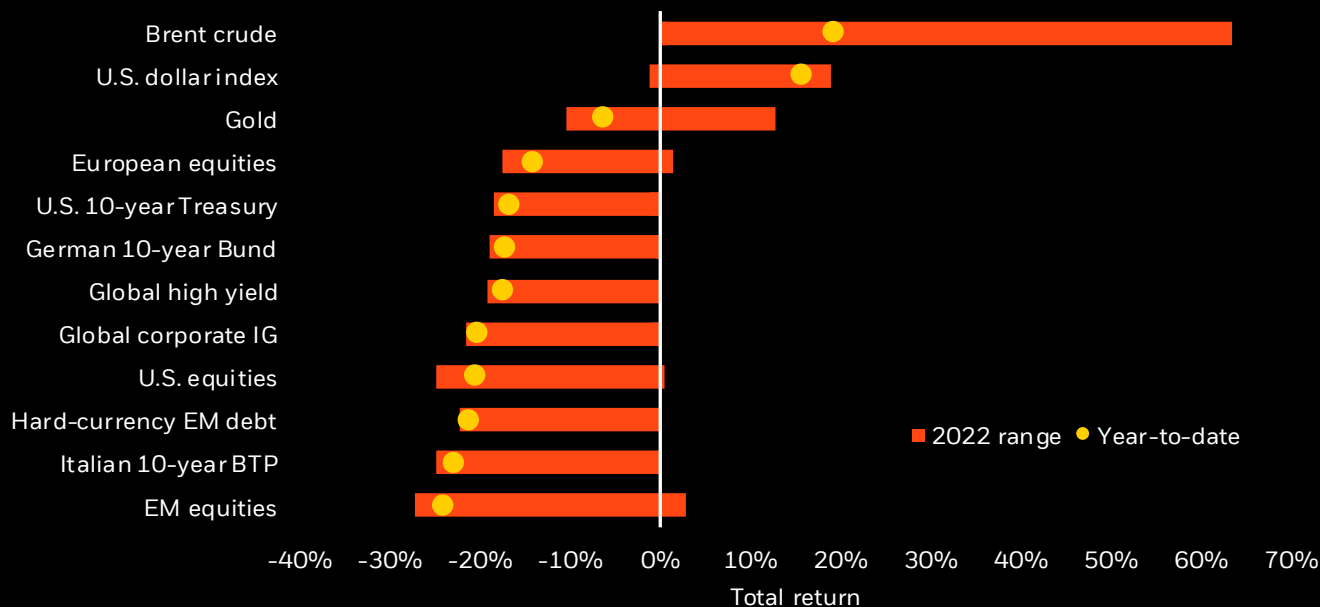
What does this mean for investments? We believe private assets – while not appropriate for all investors – still have a sizeable role to play in strategic portfolios thanks to their potential diversification properties and returns. We're underweight private markets as a whole but from a starting allocation that is much larger than what we see in institutional portfolios. As these long-term commitments reprice more, we see potential opportunity in private infrastructure given rising investment and the potential for resilient cash flow and a degree of inflation protection. Asset selection is vital, in our view, given the high dispersion of performance even within the infrastructure sector. Investment horizon is key, too. Investing takes time in private markets – funds can take up to five years to invest and over a decade to realize performance. Private markets are complex and may not be suitable for all investors.

## Market backdrop

U.S. stocks slumped back near their lows of the year and short-term Treasury yields pushed near 15-year highs. September U.S. payrolls on Friday showed job gains in line with consensus with no improvement in the supply of labor. We don't think this changes the Federal Reserve's singular focus on inflation since it hasn't acknowledged the policy trade-off. This underscores why we think the Fed will trigger a recession – and we don't think hard-hit risk assets reflect the likely damage.

## 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 Oct, 6, 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.

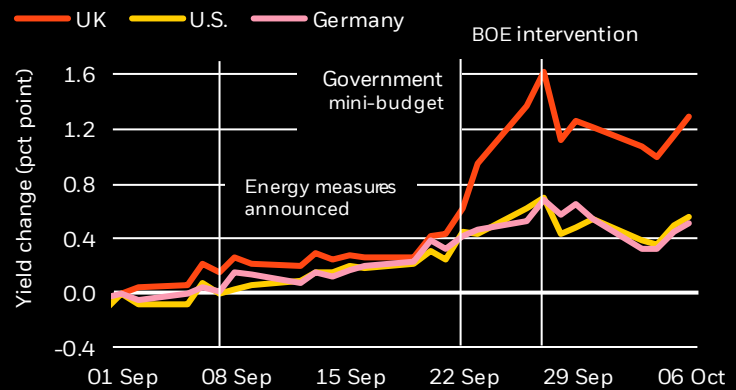
## Macro take

Markets questioned the credibility of the UK government's recent "mini-budget" – tax cuts on top of energy bill subsidies – and the borrowing it entails. Gilt yields (borrowing costs for the UK government) soared to their highest level since the financial crisis in 2008. See the chart.

Doubts could creep in about the government's commitment to low inflation. Markets may fear fiscal dominance, where the government's fiscal plans take priority over the Bank of England's inflation-fighting objective. The government may wish to deliberately, but stealthily, stoke higher inflation as a way to erode the value of its debts. Such risks are serious and threaten the credibility of the central bank. And it can be self-fulfilling: higher expected inflation pushes up actual wage and price inflation. To combat that dynamic, the Bank of England would need to generate an even deeper recession to offset those price and wage rises. To avoid that, the government's medium-term fiscal plan, due in coming weeks, will need to be watertight and backed with independent economic forecasts. Read our [Macro Take](#).

## Markets question UK fiscal credibility

Change in 10-year government yields, Sept.-Oct. 2022



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2022. Notes: The chart shows the change in yields on UK 10-year gilts (orange line), U.S. 10-year Treasuries (yellow line) and German 10-year bunds (pink line) since Sept. 1, recording the yield at the close of each business day. The vertical lines denote the start of the business day each event took place.

## 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. 10-17**

China total social financing and lending data

**Oct. 13**

U.S. CPI inflation

**Oct. 11**

UK employment









**Oct. 14**

China PPI; University of Michigan consumer sentiment

The U.S. CPI this week will be key for gauging the size of coming Fed rate hikes after the September jobs data reinforced expectations of more large hikes ahead. We think the Fed's singular focus on bringing down inflation will trigger a recession – and we only see it stopping once the damage becomes clear. We should also see China's credit data.

## 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			
<b>Equities</b>	 <p style="text-align: center;">+1</p>	 <p style="text-align: center;">-1</p> <p>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.</p>			
<b>Credit</b>	 <p style="text-align: center;">+1</p>	 <p style="text-align: center;">+1</p> <p>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.</p>			
<b>Govt bonds</b>	 <p style="text-align: center;">-1</p>	 <p style="text-align: center;">-1</p> <p>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.</p>			
<b>Private markets</b>	 <p style="text-align: center;">-1</p>	 <p>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.</p>			

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# 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
<b>Developed markets</b>	-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.
<b>China</b>	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.
<b>Emerging markets</b>	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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