

Weekly commentary

October 17, 2022

BlackRock

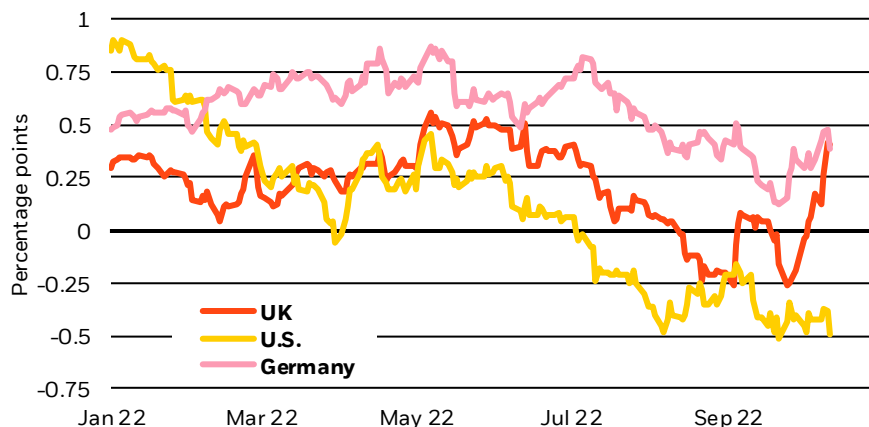
No recession cover in sovereign bonds

- We're underweight government bonds because yields have room to move higher, and we don't think they can be a safe haven when recession comes.
- Stocks were choppy and short-term U.S. Treasury yields jumped after data showed persistent U.S. core inflation. We think this is bad news for risk assets.
- China's activity data will help gauge how the economy is holding up given Covid restrictions. UK inflation data will likely reinforce expectations for further hikes.

Recession fears are roiling markets. Investors traditionally take cover in sovereign bonds, but we see this recession playbook as obsolete. Why? First, central banks are hiking rates to try to tame inflation, causing recessions. Second, we don't see them cutting rates like they typically do in recessions due to persistent inflation. Third, we expect investors to demand more compensation for the risk of holding government bonds amid high debt loads. Result: We stay underweight Treasuries.

UK yields a glimpse of the future

Government bond yield curves, Jan.-Oct. 2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2022. Notes: The chart shows the yield spread as measured by the 10-year bond yield minus the two-year bond yield in the following countries: U.S. (yellow line), UK (orange) and Germany (pink line).

In the Great Moderation, a period of steady growth and inflation, central banks would have eased policy on signs of contracting growth. That era is over. Now central banks are set to induce recessions by overtightening policy. In this supply-driven recession, high inflation and rising rates may break the fragile equilibrium where investors tolerated surging debt loads and forwent a higher term premium, or compensation for the risk of holding long-term bonds. The UK offers a glimpse of this. Long-missing bond vigilantes are back as markets question UK macro policy credibility. And financial dislocations have accelerated and amplified the move. The difference between 10-year and two-year gilt yields (orange line in chart) has surged. Yet yield curve moves of German bonds (pink) and Treasuries (yellow) show a muted response not yet pricing in a higher term premium.



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We see long-term yields rising across developed markets. Why? Policy, inflation and debt. Central banks in the new regime face a sharper trade-off between growth and inflation than in the past. Yet their forecasts, as well as the International Monetary Fund's update last week, aren't acknowledging that the cost of bringing inflation down to targets is triggering recession, in our view. We think central banks will eventually halt rate hikes. But they won't have done enough to get inflation all the way back down to target, implying they won't be able to start easing policy, in our view. Higher policy rates and inflation create a ripe environment for investors to demand higher term premia for long-term bonds.

All of this underscores why the old recession safe-haven playbook doesn't apply. That's no mere musing: We see it playing out in the UK in real time. The energy crisis had already put the UK on the brink of recession. The Bank of England (BoE) could exacerbate the pain by hiking rates even more than originally expected to offset fiscal stimulus. Backlash to the planned stimulus has sparked a gilts selloff and led to the finance minister's resignation. The BoE's two-week buying of long-term bonds helped briefly drag down yields, but they spiked anew as the program ended last week. While the government has trimmed its tax cut plans, they have already dented UK fiscal credibility and would still add to the debt build-up during the Covid-19 shock. In this environment, bond vigilantes are back and heralding term premium's return.

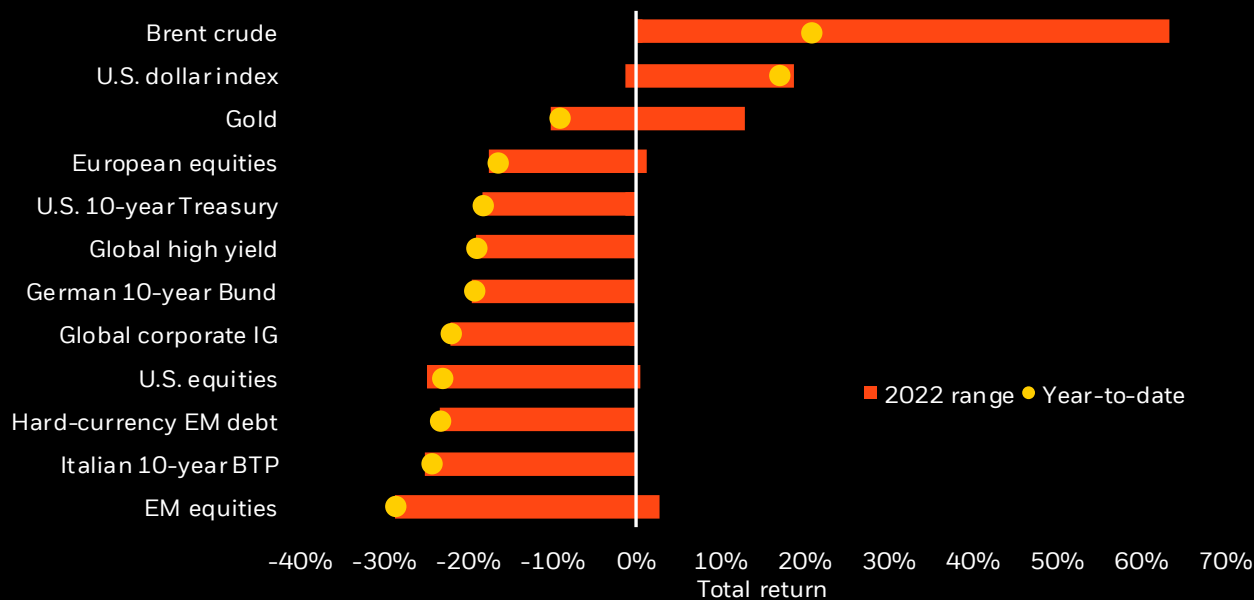
The upshot: We're broadly underweight government bonds. U.S. bond returns are the most positively correlated to stocks in two decades on a 90-day rolling basis. We expect that correlation to stay positive, erasing bonds' role as portfolio diversifiers. We don't think long-term yields reflect the likely persistence of inflation and higher term premia coming as a result. Higher short-term rates also make the long end less attractive because investors can get decent returns in short-dated bonds with less interest rate risk. We stay underweight U.S. Treasuries. Policy rates would need to hold steady or fall for Treasury returns to flip positive, we find. We previously cut UK gilts to underweight on fiscal credibility concerns. We're neutral on euro area bonds as we think expectations for European Central Bank rate hikes are too hawkish. But we're underweight Italian bonds. Italy shares some of the UK's vulnerabilities – worsening fundamentals from a current account deficit and a heavy debt burden. Strategically, we're underweight developed market government bonds and see yields higher in five years and beyond. We prefer inflation-linked bonds both tactically and strategically given they are not pricing in persistent inflation. We like high quality credit: Strong corporate balance sheets should limit default risks even in a recession, in our view.

Market backdrop

Stocks fell and short-term U.S. Treasury yields hit 15-year highs, further inverting the yield curve, after the U.S. core CPI hit a 40-year high of 6.6%. We think this shows that the U.S. economy is running above its constrained production capacity, including the labor market, reinforcing the Fed's singular focus on price pressures. We see the Fed overtightening policy and only stopping when confronted with the economic damage of its rate hikes in 2023.

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. 13, 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

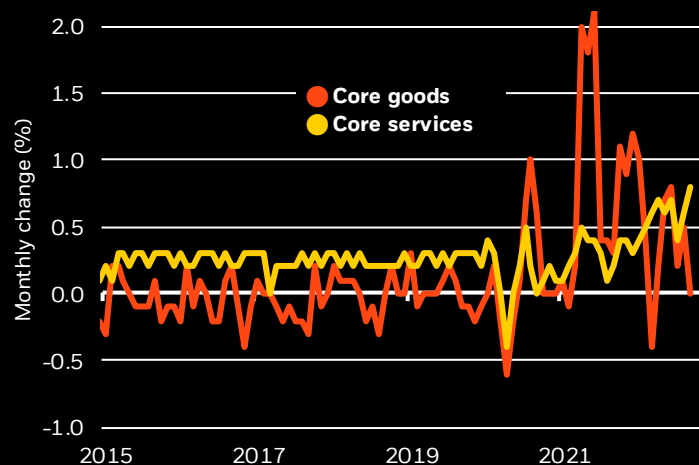
Core inflation, a metric excluding energy and food, is still rising in the U.S. Last week's consumer price index data showed prices rose by 0.6% in September. Monthly core goods inflation fell to zero – a positive sign that spending is normalizing again after Covid-19 lockdowns. But that was overwhelmed by rapidly rising services prices. See the chart.

Persistently high core inflation is likely to reinforce the Fed's hiking intentions. It is more worried about doing too little on inflation than too much. But this is a different inflation disease than that of the past 40 years and so is the cure. Hikes won't ease the production constraints that are the root cause of high inflation – only the symptom. That means the Fed will have to crush the parts of the economy that are sensitive to interest rates much more if it wants to get inflation back down to 2%. The economic damage that will cause will eventually force the Fed to pause, we think – and before it's achieved its inflation goals.

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Not yet cooling off

U.S. core CPI goods and services inflation, 2015–2022



Source: BlackRock Investment Institute and U.S. Bureau of Labor Statistics with data from Haver Analytics, October 2022. Note: The chart shows the monthly changes in U.S. core CPI goods and services inflation.

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) is set to push rates into restrictive territory even as the economy is on the brink of recession. Even after the government abandoned some of its fiscal stimulus plans, the BoE's intervention in bond markets highlights 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. 18

China Q3 GDP and activity data

Oct. 20

U.S. Philly Fed index; Japan CPI

Oct. 19

UKCPI

Oct. 21

UK retail sales; euro area consumer confidence

Markets will turn to China’s monthly data to gauge how the economy is holding up given ongoing Covid-related restrictions. The UK’s CPI should confirm inflation is staying sticky. While the UK fiscal drama has been the main focus, any fiscal stimulus could push the Bank of England toward more rate hikes despite signs the economy is starting to contract.

Directional views

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



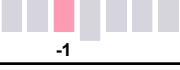

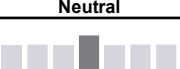


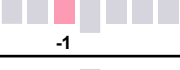







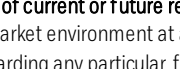

		Underweight	Neutral	Overweight	● Previous view
Asset	Strategic view	Tactical view			
Equities	<p style="text-align: center;">+1</p>	<p style="text-align: center;">-1</p> <p>We are overweight equities in our strategic views. A higher risk premium and worsening macro backdrop lowers our expected equity 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>			
Credit	<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>			
Govt bonds	<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>			
Private markets	<p style="text-align: center;">-1</p>	<p style="text-align: center;">—</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
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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