Weekly commentary

BlackRock.

October 24, 2022

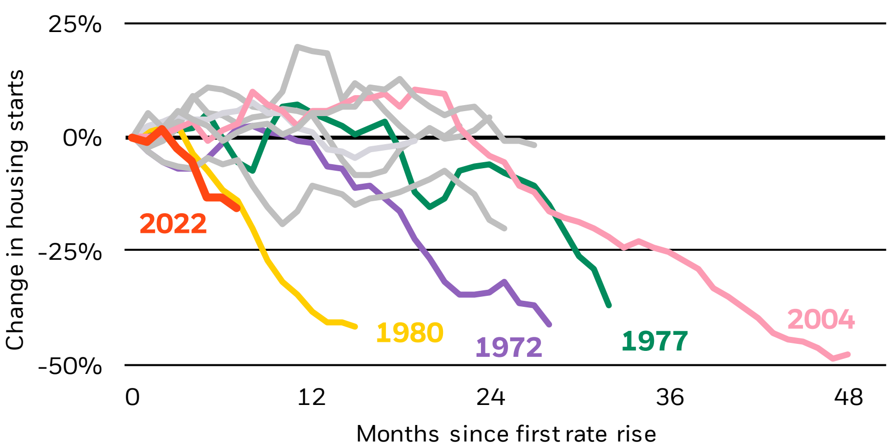
Recession eclipses U.S. midterm result

- The recession we see from Federal Reserve rate hikes eclipses any impact from U.S. midterm elections. We stay underweight developed market (DM) stocks.
- Yields rose and stocks rallied off lows as markets mulled the scope of central bank rate hikes amid a "whatever it takes" campaign to curb high inflation.
- Markets are pricing another 0.75% rate hike by the European Central Bank this week. U.S. PCE inflation will be in focus before the Fed's meeting next week.

Equities usually do well after U.S. midterms. Why? Gridlock is common and prevents policy change that could spook stocks. We don't see that past playbook working this time due to the recession we expect from the Fed ratcheting up rates. Gridlock dims any prospect of fiscal stimulus that only works at cross-purposes with monetary policy in the new regime – take the UK. We stay underweight DM stocks but see the politics of higher rates taking over from the politics of inflation.

Housing stops

U.S. housing starts during policy rate tightening cycles, 1972-2022



Sources: BlackRock Investment Institute and U.S. Census Bureau, with data from Refinitiv Datastream, October 2022. Notes: The chart shows how quickly in months housing starts changed during policy rate tightening cycles between 1972-2022. The colored, labeled lines highlight 2022 and the years when housing starts fell most quickly.

We see a bigger problem for stocks than any potential positives from the midterm election outcome: a looming recession. We have argued how central banks rushing to hike policy rates to get inflation back to target would need to crush interest rate-sensitive parts of the economy first. That's because higher inflation is driven by production constraints. Recession will pressure other sectors in time, but we' re already seeing damage in important rate-sensitive sectors like housing. As mortgage rates soar along with the Fed's aggressive rate hikes, the number of new housing starts is falling quickly. The slide in housing starts this year (see orange line in the chart above) is already steeper than past mega Fed rate-hike cycles such as in the 1970s and early 1980s – as well as the unwind of the mid-2000s U.S. housing boom (other colored lines).

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BlackRock **Investment** Institute

We've said the playbook from the Great Moderation, a four-decade period of steady growth and inflation, won't work in this new regime of heightened macro volatility. Recession outweighs factors in previous U.S. midterm elections that were seen as positive for stocks, such as resulting policy gridlock. Gridlock typically meant lower odds of change that could affect stocks. Equities also have yet to fully reflect recession and earnings risk, we think. We're not chasing bear market rebounds.

The midterms won't sway our view. Recession matters more and any resulting fiscal stimulus can only work at cross purposes when inflation and debt levels are high, and rates are rising. We've seen how it can threaten a fragile equilibrium and revive bond vigilantes. Case in point: the UK. The episode of historic long-term gilt volatility shows what can happen when governments try to respond to high inflation with unfunded fiscal spending. We've moved to neutral on UK gilts from underweight as perceptions of fiscal credibility have improved after the U-turn on the fiscal mini-budget. We think the Bank of England will have to hike rates less than we assumed immediately after the plan. Still, political turmoil and the resignation of Prime Minister Liz Truss, warrant caution. Fiscal policy can't save the day, we think – it's a recession foretold. Production constraints mean the only way to get inflation down to target would be to curb the level of activity to what the economy can comfortably produce now. We don't think fiscal stimulus would result in stronger growth but just higher interest rates and debt servicing costs.

We see political focus increasingly shifting to the economy. We expect inflation to come down, but stay above target – and recession will still hit. We then think the politics of inflation could switch to the politics of higher interest rates. We see the politics of rates creeping into the politicization of everything with more voices beginning to decry the aggressive rise in interest rates that is causing recession. We see the Fed stopping its hikes amid the economic damage and pressure to ease up on tightening, but price pressures will persist. That's why we think it will eventually have to live with some inflation.

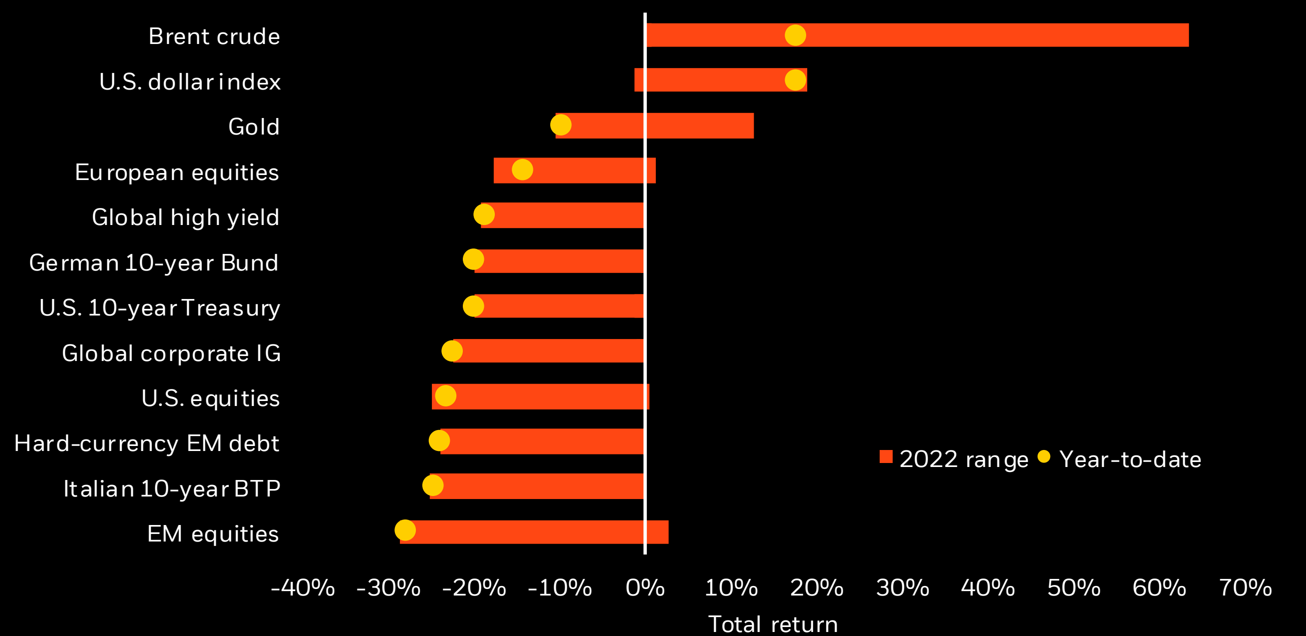
Our bottom line: We're underweight DM equities. We see rising rates causing recession as inflation persists. The Fed is responding to the politics of inflation, or the pressure to tame it, we think. We see the Fed pausing but only after the economic damage of rate rises is clear. All this outweighs any expected boost for stocks after the midterms, in our view. We also think any resulting fiscal stimulus would only work against monetary policy in this new regime. We eventually see the politics of rates overtaking the politics of inflation as political focus sharpens on the economy into the 2024 elections.

Market backdrop

U.S. and German bond yields hit new multi-year highs as markets brace for more central bank rate hikes. That has kept equities pinned near two-year lows despite occasional bear market rallies. Major central banks are expected to deliver big rate rises at upcoming meetings as they pursue a "whatever it takes" approach to curb inflation, starting with the European Central Bank next week. We expect them to carry on until the economic damage caused becomes clear.

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. 20, 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.

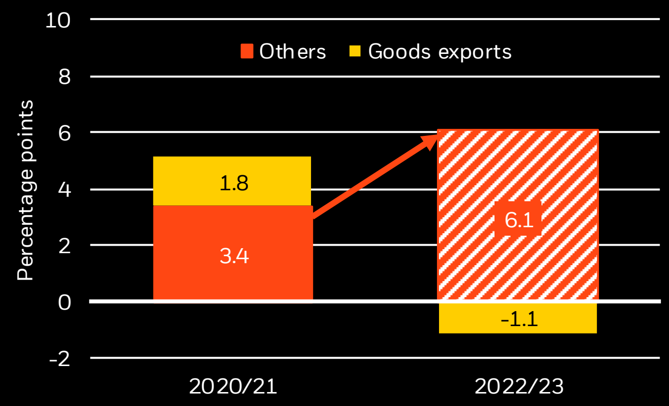
Macro take

China's growth challenges go beyond Covid. Even if the country starts to ease its zero-Covid policy, there is another underlying issue that we think will significantly challenge Chinese growth next year and beyond: fading foreign demand for China's exports.

During the pandemic, China benefited from the sudden splurge on goods by locked-down consumers in developed markets. Its exports surged, boosting economic growth by 1.8 percentage points. See the chart. But demand for Chinese goods is starting to slow. The West is emerging from Covid restrictions and people prefer to spend on traveling and socializing again, or they're tightening their belts amid the cost-of-living squeeze. We think the volume of exports could shrink by 6% on average in 2022 and 2023. That would knock around 1.1 percentage points off growth this year and next. Domestic demand would have to nearly double to achieve 5% growth, roughly the authorities' target for 2022. Read our latest Macro Take to see why we think that's unlikely.

China growth driver going into reverse

Actual, projected and implied contributions to GDP growth



Source: BlackRock Investment Institute, with data from Haver Analytics, October 2022. Notes: The left bar shows the percentage-point contribution to GDP growth of goods exports (yellow) and of all other sources (orange). The right bar shows the expected percentage-point contribution to growth from goods exports (yellow) and the implied percentage-point contribution to growth from other sources that would therefore be needed to achieve an overall GDP growth rate of 5%.

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. The former government's fiscal stimulus plans, now abandoned, forced BoE bond market intervention and highlight 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. 24	Global flash PMIs	**Oct. 27**	European Central Bank policy decision; U.S. GDP
Oct. 25	U.S. consumer confidence	**Oct. 28**	U.S. PCE; Bank of Japan policy decision

We expect the European Central Bank to stick to an aggressive tightening path and raise rates on Thursday. The Fed's preferred metric for inflation – the PCE for September – comes out on Friday, a week before markets see it lifting policy rates 0.75% to 3.75-4.0%. Manufacturing data around the world could also give early signs of the recessions we expect.

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 think markets are underappreciating the persistence of high inflation and the implications for investors demanding a higher term premium. 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	● Neutral	We are neutral UK gilts. Perceptions of fiscal credibility have improved, though not fully, after a reversal of planned fiscal stimulus. We think the BoE will have to hike rates less than we assumed immediately after the Sept. 23 "mini budget."
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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