Weekly commentary

BlackRock

October 31, 2022

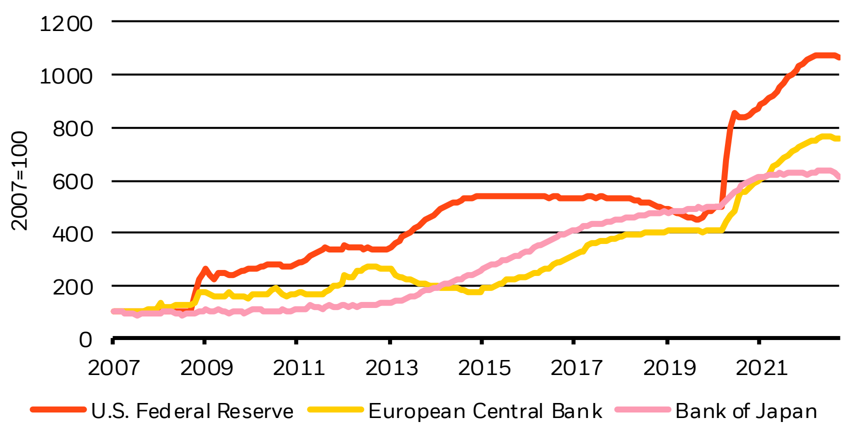
Central banks tightening from all sides

- We see central banks on a path to overtighten policy. Their balance sheet reductions up selling pressure on government bonds, so we're underweight.
- We think rates will – and may already have – hit levels that make recessions foretold. That isn't yet reflected in earnings and market pricing, in our view.
- The Federal Reserve is set to raise rates by 0.75% for the fourth consecutive time. U.S. jobs data will be closely tracked for signs of the labor market cooling.

Markets are rallying on hopes policy tightening is nearing an end – prematurely, in our view. We think the Fed, like other developed market (DM) central banks, will only stop when the severe damage from rate hikes is clearer. Rates have already hit levels that may trigger recessions, in our view. Plus, shrinking central bank balance sheets put selling pressure on long-term government bonds and risk causing market mayhem. That keeps us underweight stocks and government bonds.

Balance sheets to shrink

Central bank balance sheets, 2007-2022



Sources: BlackRock Investment Institute and Refinitiv Datastream, October 2022. Notes: The chart shows central bank total assets rebased to 100 at the start of 2007 for the Federal Reserve, European Central Bank and Bank of Japan as a measure of how much quantitative easing or tightening central banks have been conducting.

Rate hikes have consumed the market's attention this year. And rightly so. Central banks are taking a "whatever it takes" approach to pushing inflation back down to their targets, in our view. Just last week, the European Central Bank (ECB) raised rates another 0.75%. Markets expect the Fed to do the same this week. That's a record pace for the ECB – one it's signaled may slow – and the fastest hiking cycle for the Fed since the 1980s. Most major central banks aren't fully acknowledging that hiking enough to tame inflation will cause recessions, as we see it. There's another specter looming over markets: balance sheet reductions, or quantitative tightening (QT). Balance sheets have already started to dip this year. See the chart. Central banks selling or ceasing to buy government bonds could increase the risk of financial dislocations from yield spikes sparking risk asset selloffs.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Alex Brazier
Deputy Head – BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist – BlackRock Investment Institute

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BlackRock **Investment** Institute

Bond yields have already jumped markedly this year. U.S., euro area and UK 10-year bond yields have each surged nearly 250 basis points since the start of the year. That's primarily because markets are expecting higher policy rates. And investors aren't yet demanding significantly higher compensation, or term premium, for the risk of holding long-term bonds, as we've said before. QT could push up term premium, boosting the structural increase we see ahead as markets price in inflation risk and rate volatility in this new regime.

The process, timing and effects of QT will play out differently across central banks. The Fed trims its balance sheet by letting bonds run off, or reach their maturity date without replacing them, rather than selling them. That process started in June. It's unclear how long it will continue for, but the trimming of the $9 trillion balance sheet increases the risk of overtightening policy as the Fed keeps up aggressive rate hikes. A $2.2 trillion drop in the balance sheet over three years would hit bond markets the same as a roughly 30-basis-point hike in a normal scenario – and an 80-basis-point hike in times of crisis, Atlanta Fed research shows. The U.S. Treasury is looking at potential disruptions to trading liquidity, asking primary bond dealers if it should buy back some less-traded bonds to reduce volatility as liquidity, or the ability to trade, has deteriorated.

Kicking off its QT, the ECB said that in November it would start incentivizing banks to hand back the emergency cash they borrowed and no longer need. Bond runoffs may be in store for next year. QT could widen the differences between the yields for member countries' bonds. That's particularly a concern for Italy, given its current account deficit and heavy debt load. The ECB's anti-fragmentation tool and continued reinvestment of maturing bonds during its pandemic program may stave off some widening of peripheral yield spreads. This week, the Bank of England (BoE) will become the first major central bank to sell bonds as part of QT, temporarily delayed during the turmoil of the long-term gilt selloff that prompted renewed purchases. The UK episode shows how financial dislocations can cause a delay or pause in QT programs. That may feed perceptions of financial dominance – that central banks have no choice but to keep buying bonds due to market strains.

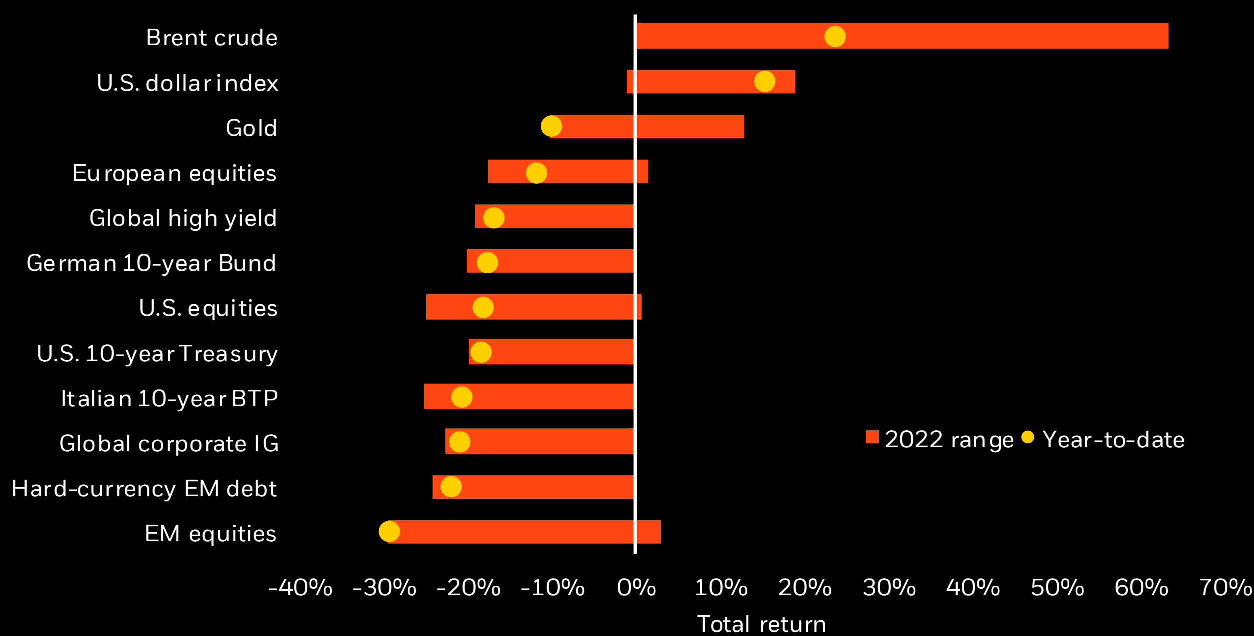
Our bottom line: We think further, if slower, rate hikes are coming along with QT. QT may add to market strains and reasons why investors start demanding term premium, driving long-term bond yields higher, so we stay underweight DM bonds. Within an underweight to Treasuries, we prefer short-dated bonds given better returns and less duration risk. We stay underweight DM stocks whose valuations don't reflect the recession we expect to hit corporate earnings.

Market backdrop

Developed market stocks rebounded and bond yields last week fell on hopes that major central banks will start to slow and halt rate hikes. We don't see this as a catalyst to turn positive on risk assets. Rates will – and may already have – reached levels that constitute overtightening, making recessions foretold, in our view. The U.S. PCE data may embolden the Fed and is consistent with it pushing ahead with hikes causing major economic damage if it wants to bring inflation down to target.

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. 27, 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

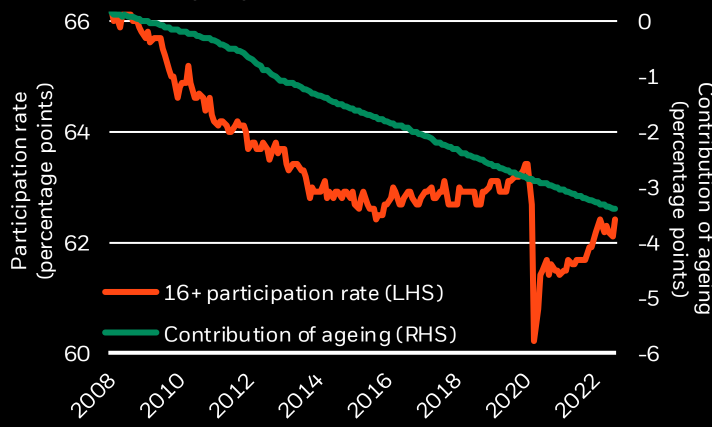
A key factor driving up prices in the U.S.? Not enough workers to comfortably maintain the current level of production. The share of the adult population in work, or actively looking for work – also known as the participation rate – is still well below where it was before the pandemic began. See the orange line on the chart.

We see little chance of that recovering back to pre-Covid levels. Why? Because the vast majority of the decline is due to aging. In 2010, 16.3% of the adult population was over 64: the point at which many typically retire. That rose to 20.6% in 2019, and has risen further in the past two years to 21.6%. That explains the downward trend in the participation rate since 2010 – and it accounts for most of the 1.1 percentage point drop since the pandemic started. See the green line on the chart. That's only set to get worse as the population continues aging.

Read our latest Macro take to find out more about what an older population means for future U.S. growth.

Workforce shortage down to ageing

Contribution of ageing to fall in participation rate, 2008-2022



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, October 2022. Notes: The orange line shows the U.S. labor force participation rate – the share of the adult population (aged 16 +) in work or actively looking for work. The green line shows the contribution aging has made to the fall in the participation rate since 2008, calculated by fixing participation rates for each group and changing the weights as observed in the population data over the sample period.

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 raised interest rates another 0.75% in October, but a change in tone suggested it was poised to slow the pace of hikes. We think the ECB is still raising rates into a recession triggered by the energy shock and its hikes – and it will only stop once it sees the scale of economic damage caused.
- **Investment implication**: We are tactically underweight 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. 31	Euro area GDP and inflation	**Nov. 3**	Bank of England policy decision
Nov. 2	Federal Reserve policy decision	**Nov. 4**	U.S. payrolls

All eyes are on the Fed as it is set for a fourth straight 75 basis point hike. Markets are hoping it will slow and eventually stop hiking. But we think the Fed will only stop raising rates once the economic damage from their tightening becomes clear. U.S. payrolls will be closely watched for any signs of whether slowing activity is impacting demand for labor.

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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