Weekly commentary

BlackRock

November 7, 2022

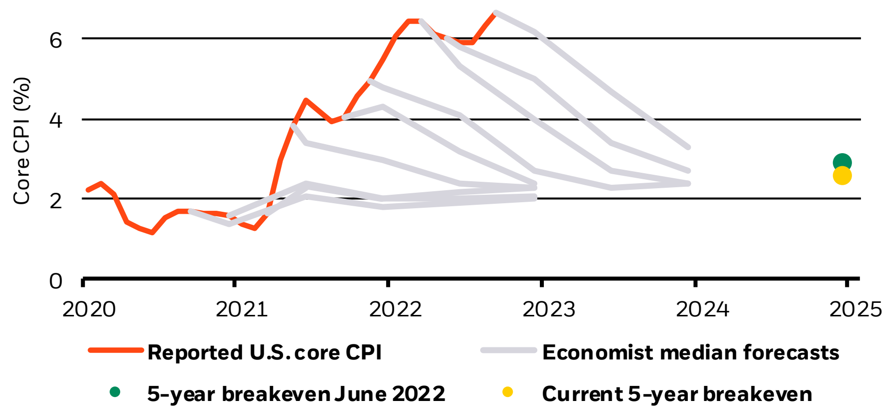
Forum takeaways in new regime

- BlackRock's top investment leaders came together at the Outlook Forum. The upshot: The new regime is not about to change, and we need a new playbook.
- Stocks slid and yields rose as the Federal Reserve delivered another mega rate rise and signaled it would need to take rates even higher than originally planned.
- U.S. inflation is in focus this week after the jobs data showed ongoing worker shortages. We don't think the data will deter the Fed from overtightening.

We see the new regime of greater macro and market volatility playing out. This backdrop made for a spirited Nov. 1-2 Forum, a semiannual gathering of BlackRock's top investment leaders to debate the outlook. We think this new regime is not about to change, and debated how to navigate a recession foretold, persistent inflation, geopolitical fragmentation, a strong U.S. dollar and the energy crunch. Watch for our updated views in our 2023 Outlook on Nov. 30.

Wishful thinking on inflation

Core CPI inflation, forecasts and breakeven rates, 2020-2025



Sources: BlackRock Investment Institute, with data from Bloomberg and Refinitiv Datastream, November 2022. Note: The gray lines show consensus economist projections of CPI inflation reported by Reuters. The yellow dot shows market-implied five-year-ahead inflation expectations as of Nov. 1. The green dot shows the same expectation as of June 14.

The constant upside surprises in inflation relative to median forecasts (gray lines) are at the heart of market volatility – and underscore that we are in a new regime of greater macro and market volatility. Market pricing (green and yellow dots in chart) shows markets continue to expect a normalization of inflation. We think core inflation will be sticky primarily due to ongoing production constraints, especially in the labor market. Those constraints mean economies are overheating, even though activity hasn't reached its pre-Covid trend. Central banks are set to overtighten, pushing economies into moderate recessions. But a deep recession is coming *if* central banks insist on bringing inflation fully back down to target as quickly as they typically aimed to do in the past.

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BlackRock **Investment** Institute

We see the new regime playing out. Central banks face sharper trade-offs between activity and inflation. For now, we see them on a path to overtighten and cause recessions while attempting to bring inflation back to target. A resilient economy only makes further overtightening more likely, in our view, and would be even worse for the economy – and bad news for risk assets. The risk of financial cracks is also real. We think central banks will eventually pause their hikes once confronted with the economic damage they've caused. That would mean living with some higher inflation if production capacity doesn't come back quickly.

The new regime is not about to change, in our view – reinforced by three big transitions that mean repeated drags on production capacity and thus persistent inflation. First, aging populations are limiting the number of working-age people and will place pressure on public finances. Second, we think the era of great geopolitical moderation has ended, leading to a persistent geopolitical risk premium, exemplified by rewiring global supply chains and strategic competition between the U.S. and China. This is the most fraught environment we have seen in the world in the post-World War Two era. Third, we see the transition to net-zero carbon emissions reshaping energy demand and supply over time.

So how should investors adjust to all this? The new regime needs a new investing approach. We think ongoing sizing of what's in the price of a given asset is crucial. It will matter more than trying to time a sustained bull market, in our view. Investors learned it paid to "buy the dip" during the bull markets of the "Great Moderation," a multidecade period of stable growth and inflation that is over now. The urge is still there, much like all characters in *The Lord of the Rings* are drawn to the power of the One Ring – but what promised gains before now promises pain, we think. We must avoid the ring's temptation – the old playbook – to buy dips or time rallies. Doing so risks ruining one's life, like Gollum, or one's portfolio in the new regime. This is true for stocks as well as bonds. Central banks are hiking rates and causing recessions, not responding to them by cutting rates. So we think long-term government bonds won't offset risk asset selloffs like they did in past recessions.

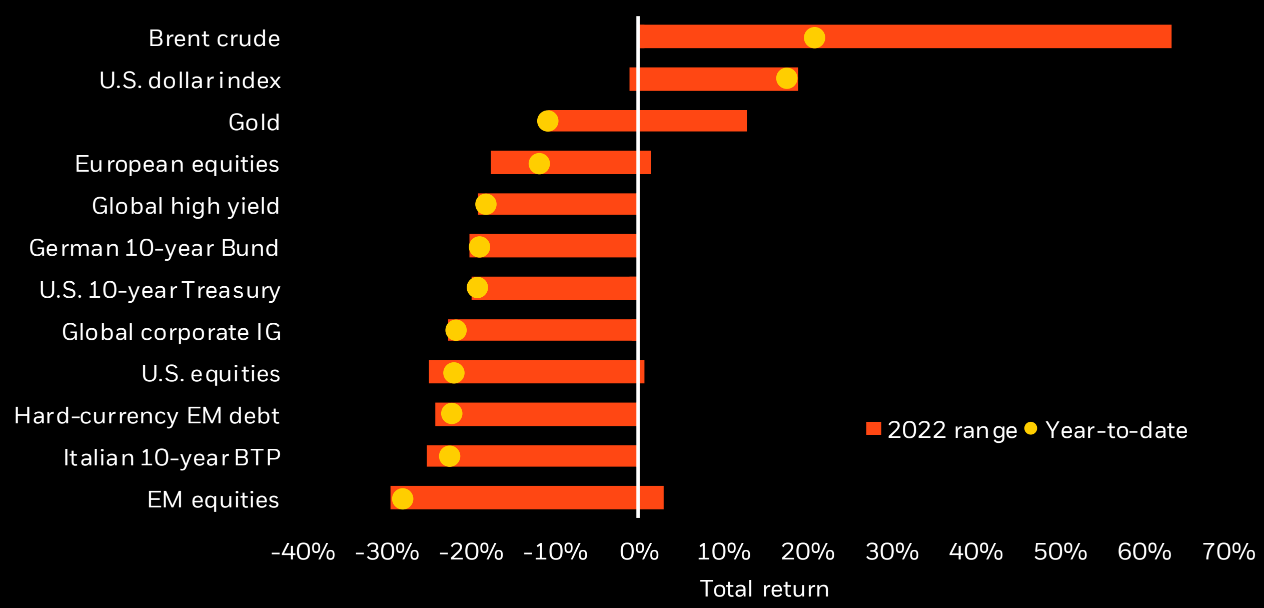
Our bottom line: The new regime is here to stay. We need to make more frequent portfolio changes and plan for more granular allocations to pounce on opportunities – and avoid the temptations of the One Ring. In the near term, attractive yields on short-term credit make it an appealing place to wait out the coming recession, we think. We don't think equities have fully priced recession risks – and earnings forecasts still look too optimistic. Stay tuned for our 2023 Outlook on Nov. 30.

Market backdrop

Stocks slumped and short-term U.S. Treasury yields hit 15-year highs after the Federal Reserve delivered another mega rate hike, as expected, but also signaled it would have to take rates higher than it originally planned, even if at a slower pace. Markets were disappointed again as the dovish signal they were hoping for failed to materialize, snuffing out an equity bounce. We see the Fed on a path to overtighten policy and don't expect it to pause until the damage caused is clearer.

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 Nov. 3, 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

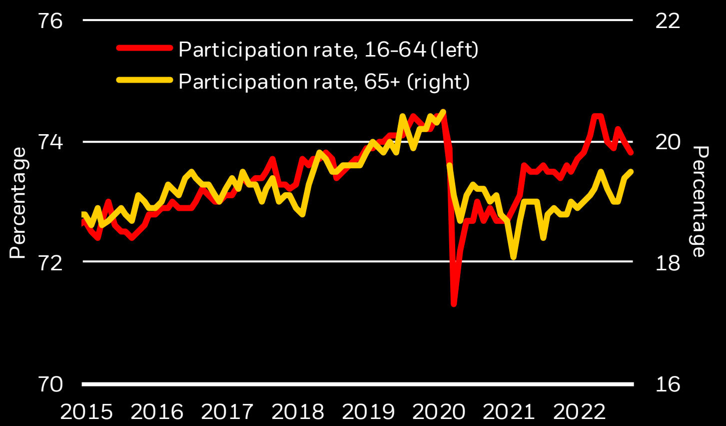
A shortage of workers in the U.S. is a key production constraint fueling inflation. What's behind the lack of labor? Covid-19 is partly to blame. The Covid shock pushed many workers aged 65 and over to retire earlier than they would have otherwise – and most won't return to the labor force, in our view. See the yellow line in the chart. We think that trend accounts for roughly 20% of the overall fall in the participation rate since the pandemic's onset. Participation among the 65+ group will take time to recover – driven largely by current 55- to 64-year-olds aging up.

But the bigger driver of lower participation, in our view? An aging workforce. Population aging accounts for most of the decline in participation over the past decade, reflecting that the over-65s are less likely to be in the labor force than people aged 16-64. Slowing population growth will mean the available workforce expands much more slowly in the coming 20 years than it did in the past 20.

Read our latest Macro take for more on how demographic shifts have reshaped the labor market.

Fewer older workers than usual

U.S. labor force participation by age group, 2015-2022



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, November 2022. Notes: The chart shows the participation rate for those aged 16-64 on the left (red line), and the participation for those aged 65 and over on the right (yellow line). Labor participation measures the share of the population of a particular age group that is either in work or actively looking for and able to work.

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 energy shock and China's lockdowns.
- We are in a new macro regime where central banks are causing recessions rather than coming to the rescue. That is clear in the rate path of major central banks set to overtighten policy as they battle inflation. We think they will eventually pause but not cut rates when confronted with the damage of sharp rate hikes – that could be the reality of recession or the appearance of financial cracks, as seen in the UK.
- The Federal Reserve delivered another mega rate hike, as expected, but also signaled it would have to take rates higher than it originally planned, even if at a slower pace.
- The Bank of England has acknowledged some recession is necessary to get inflation down, yet like other central banks, it is failing to acknowledge the scale of the recession needed to get it all the way down to target.
- The ECB continues to normalize monetary policy, but a change in tone suggests it could be 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.
- **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

Nov. 7	UK house prices; German industrial production	**Nov. 10**	U.S. CPI
Nov. 8–9	Japan trade data; China CPI	**Nov. 11**	UK GDP; U.S. University of Michigan consumer sentiment

Markets will keenly watch the U.S. CPI for any signs of easing inflation. Persistently high inflation could embolden the Fed to hike rates even more than the market expects. Consumer sentiment may give a sense of the economic damage inflicted by the Fed's tightening, and the report will also show the latest snapshot of household inflation expectations.

Directional views

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