Weekly commentary

April 17, 2023

BlackRock

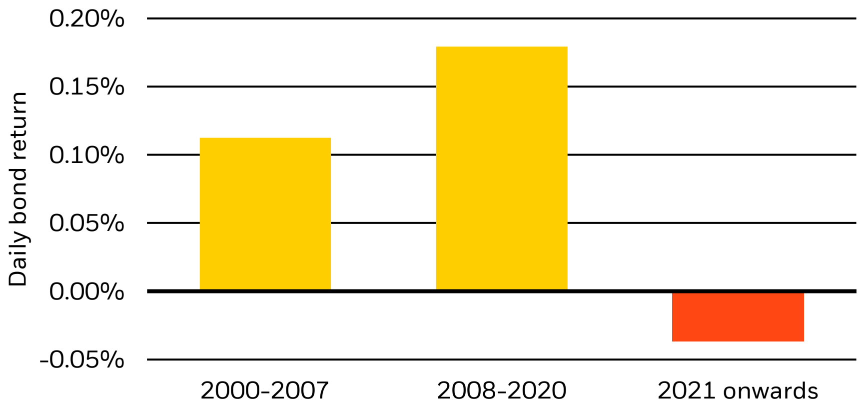
New regime, new portfolio approach

- The joint stock-bond rally this year has put renewed focus on portfolio construction approaches. We think a new macro regime needs a new approach.
- U.S. stocks rose last week but lost steam on Friday on the market partly pricing out potential rate cuts. We don't see cuts this year as core inflation stays sticky.
- U.S. earnings results pick up this week and are overall expected to slump the most in three years. We don't think that reflects the coming damage yet.

Stocks and bonds have both rallied this year. Some see this as reason to return to traditional portfolio approaches like 60% stocks and 40% bonds. Those used to work when both assets trended up and bonds offset equity slides. We think a focus on any one asset allocation mix misses the point: A regime of higher volatility with sticky inflation needs a new approach to building tactical and strategic portfolios. We see the appeal of income, get more granular with views and are more nimble.

A new relationship

Average U.S. Treasury return when equities fall, 2000-2023



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, April 2023. Notes: The chart shows the average daily return of 10-year U.S. Treasuries on days when equity prices fall. The yellow bars show these daily returns for the period 2000-2007 and 2008-2020. The red bar shows 2021 and onwards. All periods start in January and end in December for each respective range. The index used for equities is MSCI World.

An allocation based on the traditional investing approach of using broad, public indexes of 60% equity and 40% bonds is having a strong start to 2023 after the worst year in decades. We don't see the return of a joint stock-bond bull market like we saw in the Great Moderation. That was a decades-long period of largely stable activity and inflation when most assets rallied and bonds provided diversification when stocks slumped. We think strategic allocations of five years and beyond built on these old assumptions do not reflect the new regime we're in – one where major central banks are hiking interest rates into recession to try to bring inflation down. We find that bond returns provided reliable diversification for most of the Great Moderation, helping offset equity selloffs (yellow bars in chart). Some of that ballast has gone away. Average bond returns have dipped alongside equities since 2021 (orange bar) – but higher yields mean income is finally back in fixed income.

Jean Boivin
Head – BlackRock Investment Institute

Wei Li
Global Chief Investment Strategist – BlackRock Investment Institute

Paul Henderson
Senior portfolio strategist – BlackRock Investment Institute

Devan Nathwani
Portfolio strategist – BlackRock Investment Institute

Visit BlackRock Investment Institute for insights on the global economy, markets and geopolitics.

BlackRock **Investment** Institute

The merit of long-term bonds as portfolio diversifiers has fueled a debate over the future of the 60% stocks, 40% bonds portfolio. We think talking about numbers misses the point. The debate should be more about the approach to portfolio construction rather than the broad allocation levels. We believe in a new approach to building portfolios.

Our approach starts with income: The longer rates stay higher, the greater the appeal of income in short-term bonds. We see interest rates staying higher as the Federal Reserve seeks to curb sticky inflation – and we don't see the Fed coming to the rescue by cutting rates or a return to a historically low interest rate environment. This reinforces the appeal of income in short-term paper. Yet we also see long-term yields rising on both strategic and tactical horizons as investors demand more term premium, or compensation for holding long-term bonds in an environment of higher inflation and debt.

We are also breaking up traditional asset allocation buckets, moving away from broad allocations to public equities and bonds. We think strategic views need to be more granular – across sectors and within private markets – to help build more resilient portfolios in the new regime. On a tactical, six- to 12-month view, we prefer to get more granular by digging into sectors like energy and healthcare, actively selecting companies with quality characteristics: stronger earnings and cash flow that can better weather a recession, resilient supply chains, strong market share and the ability to pass on higher prices. Within fixed income, our granular approach aligns across tactical and strategic views. We're overweight inflation-linked bonds on both horizons given our expectations of persistent inflation.

We think being more nimble is key because coasting with strategic allocations can prove costly. It's even more important against a backdrop of structural forces like geopolitical tensions, the energy transition and shifts driven by banking sector turmoil. We're adjusting our strategic portfolios more frequently in response to new information and market shocks. One example: We're strategically overweight developed market (DM) equities but tactically underweight. That's because strategic investors are investing on a timeline where much of the short-term pain would be in the rear-view mirror – they can look ahead and seize opportunities now. We think that getting the asset mix right in the new regime will be crucial for maximizing returns: Our work finds that getting it wrong could be up to three times greater the impact now than in the Great Moderation.

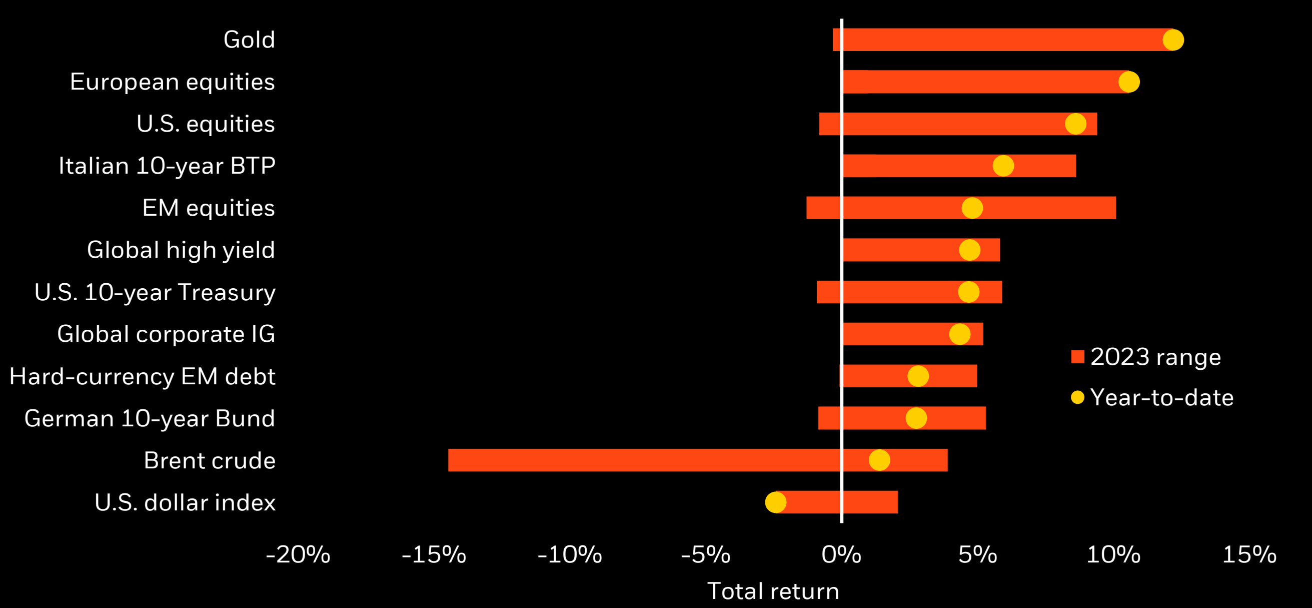
Bottom line: Our portfolio construction approach favors income while getting granular and more nimble in the new regime.

Market backdrop

U.S. stocks rose last week near 2023 highs but lost steam on Friday on the market partly pricing out potential rate cuts. The two-year U.S. Treasury yield swung back above 4.0% but remains well off the 16-year high from early March, driven by market hopes for rate cuts. The core U.S. CPI for March showed a resurgence in goods prices and persistent pressure from services. That means inflation is still not on track to fall near policy targets, in our view – so we don't see rate cuts this year.

Assets in review

Selected asset performance, 2023 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 April 13, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, 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

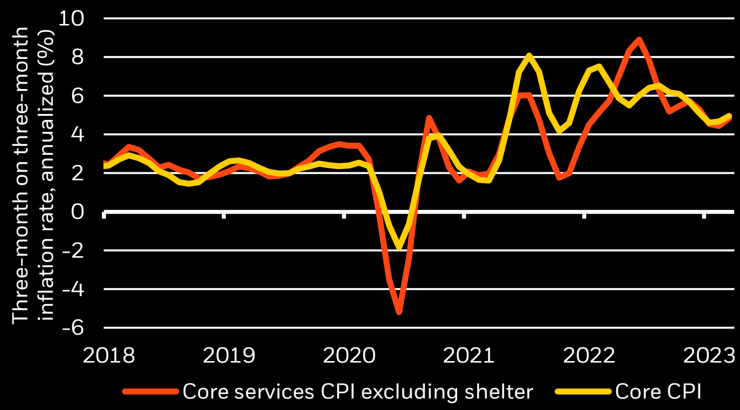
Inflation in the U.S. is not on track to settle anywhere close to the Federal Reserve's 2% target, in our view. That was reinforced by March inflation data published last week. That showed underlying inflation pressures are increasing rather than subsiding.

After a short and bumpy spell of goods prices falling – which was key to overall core inflation declining from its highs last year – core goods inflation is rising again. And core services inflation excluding shelter accelerated to 4.8% on a three-month annualized basis, up from 4.4%. See the orange line on the chart. At that pace, and with goods inflation moving the wrong way, overall core inflation is set to settle close to 4% – see the yellow line.

We think that increases the odds of the Fed hiking rates again next month, but more importantly, does not provide any basis for markets' hopes that the Fed will come to the economy's rescue with rate cuts later this year. Explore our recent Macro take blog posts here.

Inflation fight not over

US. CPI inflation, 2018-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, April 2023. Note: The orange line shows services inflation, excluding energy, rent of primary residence and owner-equivalent rent. The yellow line shows the inflation rate for all items, excluding food and energy. Both lines show the percent change in the three-month average price level over the preceding three months, expressed in annualized terms.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- The ultimate economic damage depends on how far central banks go to get inflation down. We think the Federal Reserve will halt rate hikes once the economic damage becomes clear. We see the European Central Bank going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Very short-term government paper looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication**: We prefer very short-term government paper over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The Fed's rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication**: We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

April 18	China Q1 GDP	**April 20**	U.S. jobless claims, existing home sales; euro area flash consumer confidence
April 19	UK CPI	**April 21**	Global flash PMIs; Japan CPI

U.S. first-quarter earnings results pick up this week. A few big banks led the way last Friday, beating market expectations for profit. First-quarter earnings are expected to slump the most in three years – and for the second quarter in a row, FactSet data show. We don't think that reflects the coming damage yet.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, April 2023

Underweight **Neutral** **Overweight** ● Previous view

Asset	Strategic view	Tactical view	
Equities	+1	-1	We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Credit	+1	Neutral	Strategically, we are overweight global investment grade but have reduced it given the tightening of spreads in recent months. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.
Govt bonds	Neutral	-1	We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We remain underweight nominal long-term bonds: We think markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium. Tactically, we are underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.
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, April 2023

Underweight | Neutral | Overweight | ● Previous view

	Asset	View	Commentary
Equities	**Developed markets**	-1	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
Equities	United States	-1	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
Equities	Europe	-1	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
Equities	UK	-1	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
Equities	Japan	-1	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
Equities	**Emerging markets**	+1	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
Equities	China	+1	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
Equities	Asia ex-Japan	Neutral	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
Fixed Income	Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
Fixed Income	Short U.S. Treasuries	+2	We are overweight. We prefer very short-term government paper for income given the potential for a sharp jump in Fed rate expectations.
Fixed Income	Global inflation-linked bonds	+2	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
Fixed Income	Euro area govt bonds	-1	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
Fixed Income	UK gilts	-1	We are underweight. Gilts won't be immune to the factors we see driving DM bond yields higher. We prefer short-dated gilts for income.
Fixed Income	China govt bonds	Neutral	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
Fixed Income	Global IG credit	Neutral	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
Fixed Income	U.S. agency MBS	Neutral	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
Fixed Income	Global high yield	-1	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
Fixed Income	Emerging hard currency	Neutral	We are neutral. We see support from higher commodities prices, yet it is vulnerable to rising U.S. yields.
Fixed Income	Emerging local currency	+1	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
Fixed Income	Asia fixed income	Neutral	We are neutral. We don't find valuations compelling enough yet to turn more positive.

Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. 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 or guarantee of future results. This information should not be relied upon as investment advice regarding any particular fund, strategy or security.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise and generates proprietary research to provide insights on macroeconomics, sustainable investing, geopolitics and portfolio construction to help Blackrock's portfolio managers and clients navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

BlackRock.

Not FDIC Insured • May Lose Value • No Bank Guarantee