

Weekly commentary

July 24, 2023

BlackRock

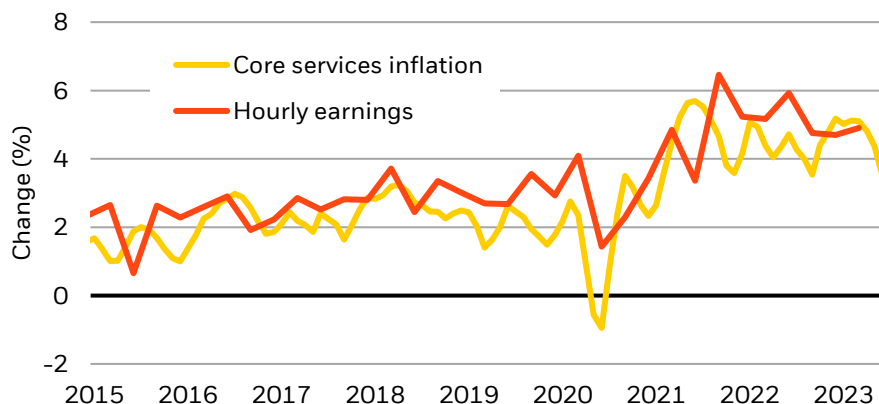
Central bank inflation fight to carry on

- Central banks are set to hike policy rates this week. Markets expect rate cuts to soon follow due to cooling inflation, whereas we see central banks holding tight.
- U.S. stocks rose last week as initial earnings updates topped low expectations. We think earnings will contract in 2023's second half as wage gains hit margins.
- The Fed and European Central Bank will likely raise interest rates again this week. We see the Bank of Japan opting to keep policy loose to sustain inflation.

The Federal Reserve and the European Central Bank (ECB) are set to hike rates again this week, yet markets have been taking this in stride. Soft June U.S. core inflation has revived hopes for rate cuts in 2024. This can fuel a bull run across assets for some time – until it runs into the disconnect between fast-falling inflation and stronger-than-expected economic activity. We look for opportunities beyond broad asset classes, such as the artificial intelligence theme in equities.

Wage-inflation connection

U.S. services inflation vs. hourly earnings, 2015–2023



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, July 2023. Notes: The chart shows U.S. core services inflation, excluding shelter, using the Personal Consumption Expenditures (PCE) price index, relative to hourly earnings based on the Employment Cost Index (ECI). The data is in three-month-on-three-month annualized terms.

The surprising fall in June U.S. core CPI inflation was clearly good economic news. Yet how can inflation suddenly be falling if the U.S. economy is stronger than expected and the labor market remains tight? First, there's a perception growth is strong. The reality is that the U.S. economy has barely grown over the last 18 months – despite historically tight labor markets and strong consumption. Second, the inflation story is complex. We are seeing a combination of 1) a shift in consumer spending from goods to services and 2) wage pressures from the tight labor market. The first is spurring goods deflation. The flip side is persistent services inflation, exacerbated by ongoing wage pressures. We expect core services inflation excluding housing (yellow line in the chart) to stay elevated due to those wage gains (dark orange line). The result? A rollercoaster trajectory over the next quarters before inflation likely settles near 3% – well above the Fed's 2% target.



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The U.S. dollar and Treasury yields slid after the CPI data, while stocks moved higher as markets embraced the hope of a “soft landing” – growth holding up and inflation coming down. This hope can sustain risk assets for some time even if it doesn’t pan out. A lot would need to go right for such an outcome, in our view. Activity would need to hold up even as the full force of the Fed’s rate hikes has yet to kick in. That may be possible if tight labor markets spur companies to hold on to workers after struggling to find them coming out of the pandemic. Inflation would also have to drop sustainably closer to 2%.

We expect a squeeze on corporate margins if inflation stays high – and an even larger squeeze if it falls. Tight labor markets are set to keep production costs high. A sustained fall in inflation could soften demand. Why? This would likely come from good prices falling further and/or labor markets weakening significantly. So good economic news like falling inflation is not necessarily good news for markets. Margins have already dropped, Refinitiv data show, suggesting companies are starting to have trouble passing higher costs to consumers. We are watching Q2 earnings for more signs of margin pressures.

We see most developed market (DM) central banks forced to hold policy tight to lean against inflationary pressure as they focus on tight labor markets. This is a key theme in our [midyear outlook](#). The Fed, ECB and Bank of England (BOE) face a similar challenge: Inflation has cooled from lower goods prices, but wage gains look set to keep services inflation sticky – and overall inflation on a rollercoaster. We see them pushing ahead on the inflation fight this week, too – though growth is weaker for the euro area and UK. The ECB and BOE have also tightened more aggressively than in the past and are still hiking. The story is different for the Bank of Japan. We think it may opt for loose policy this week to sustain above-target inflation since Japan has [fewer supply](#) constraints.

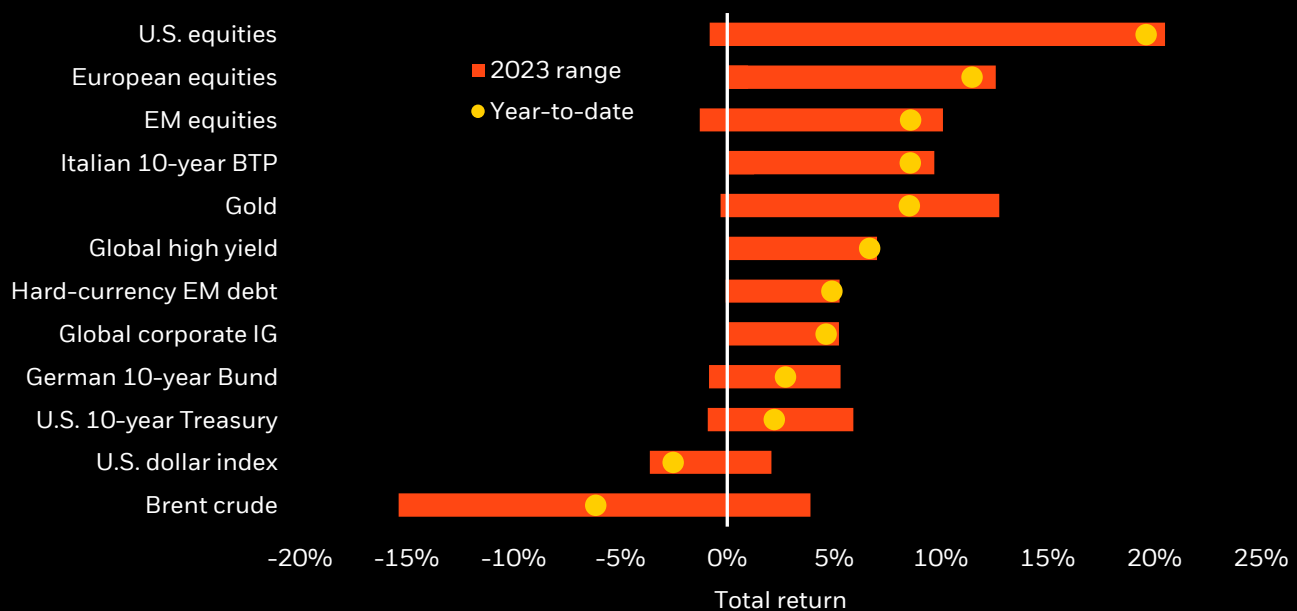
Bottom line: Soft inflation data has rekindled hopes for rate cuts in 2024, even as central banks are set to hike more in the near term and hold tight for long thereafter. We use our new playbook to look beyond broad asset classes in this tricky macro environment. We tap into the AI mega force within DM stocks. Mega cap tech led earnings forecast upgrades due to AI euphoria, and we’ll assess their Q2 earnings for ongoing strength. We upgrade UK equities to neutral as they better price in the weak growth outlook. We like Japanese stocks as loose policy looks set to support earnings. We favor U.S. inflation-linked bonds as markets underestimate inflation’s persistence. Yet we prefer euro area nominal government bonds over the U.S. as they price in rates staying higher for longer.

Market backdrop

U.S. stocks edged up on the week as early earnings updates, mostly from financials, topped low expectations. We expect Q2 results to be similar to Q1 – flat to slightly negative. We see a [contraction](#) later in the year as wage gains erode profit margins. Treasury yields steadied as markets eyed the signal from major central banks. UK markets breathed a sigh of relief on soft CPI data: Stocks climbed and 10-year gilt yields fell sharply on the week as markets priced in a lower peak in BOE policy rates.

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 July 20, 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

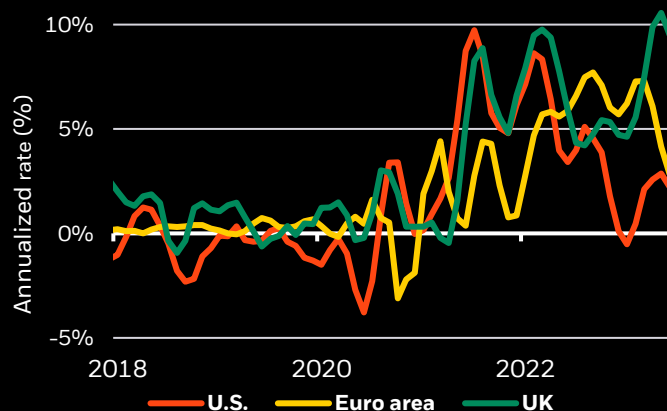
Core inflation across developed markets (DM) is falling from last year's highs. That's good news. But we think the journey back to central banks' 2% policy target remains bumpy.

The sharp rise in core inflation was driven by two shocks. The first: A massive swing in spending towards goods and away from services during the pandemic. Demand surged and businesses couldn't keep up, creating bottlenecks and soaring prices. See the chart. The second: labor shortages. Smaller workforces have created tight labor markets, with unusually low unemployment rates and companies struggling to fill job vacancies.

The good news? Spending is shifting back towards services, so goods inflation is falling. But labor markets are still tight. That will stoke wage gains and feed into services inflation. Core inflation seems set to ride a rollercoaster – dipping before climbing up again – but staying above 2%. We think that compels central banks to keep policy tight, with little room to cut rates as quickly as markets expect, especially in the U.S. See our Macro take blog posts [here](#).

Goods inflation rolling off

U.S., euro area and UK core goods inflation, 2018-2023



Source: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, Eurostat, Office for National Statistics, with data from Haver Analytics, July 2023. Notes: The chart shows the three-month on three-month annualized rate of seasonally adjusted core goods inflation for the U.S., the euro area and the UK.

Investment themes

1 Holding tight

- Markets have come around to the view that central banks will not quickly ease policy in a world shaped by supply constraints – notably worker shortages in the U.S.
- We see central banks being forced to keep policy tight to lean against inflationary pressures. This is not a friendly backdrop for broad asset class returns, marking a break from the four decades of steady growth and inflation known as the Great Moderation.
- Economic relationships investors have relied upon could break down in the new regime. The shrinking supply of workers in several major economies due to aging means a low unemployment rate is no longer a sign of the cyclical health of the economy. Broad worker shortages could create incentives for companies to hold onto workers, even if sales decline, for fear of not being able to hire them back. This poses the unusual possibility of “full employment recessions” in the U.S. and Europe. That could take a bigger toll on corporate profit margins than in the past as companies maintain employment, creating a tough outlook for DM equities.
- **Investment implication:** Income is back. That motivates our overweight to short-dated U.S. Treasuries.

2 Pivoting to new opportunities

- Greater volatility has brought more divergent security performance relative to the broader market. Benefiting from this requires getting more granular and eyeing opportunities on horizons shorter than our tactical one. We go granular by tilting portfolios to areas where we think our macro view is priced in.
- We think dispersion within and across asset classes – or the extent to which prices deviate from an index – will be higher in the new regime amid the various crosscurrents at play, allowing for granularity. That offers more ways to build portfolio “breadth” via uncorrelated exposures, in our view.
- We think it also means security selection, expertise and skill are even more important to achieving above benchmark returns. Relative value opportunities from potential market mispricings are also likely to be more abundant.
- **Investment implication:** We like quality in both equities and fixed income.

3 Harnessing mega forces

- Mega forces are structural changes we think are poised to create big shifts in profitability across economies and sectors. These mega forces are digital disruption like artificial intelligence (AI), the rewiring of globalization driven by geopolitics, the transition to a low-carbon economy, aging populations and a fast-evolving financial system.
- The mega forces are not in the far future – but are playing out today. The key is to identify the catalysts that can supercharge them and the likely beneficiaries – and whether all of this is priced in today. We think granularity is key to find the sectors and companies set to benefit from mega forces.
- We think markets are still assessing the potential effects as AI applications could disrupt entire industries.
- Geopolitical fragmentation, like the strategic competition between the U.S. and China, is set to rewire global supply chains, we think.
- The low-carbon transition causing economies to decarbonize at varying speeds due to policy, tech innovation and shifting consumer and investor preferences. Markets have historically been slow to fully price in such shifts.
- We see profound changes in the financial system. Higher rates are accelerating changes in the role of banks and credit providers, shaping the future of finance.
- **Investment implication:** We are overweight AI as a multi-country, multi-sector investment cycle unfolds.

Week ahead

July 24

Global flash PMIs

July 27

ECB decision; U.S. Q2 GDP

July 26

Fed policy decision

July 28

U.S. June PCE, Employment Cost Index; BOJ decision

The Fed and ECB are set to hike rates again this week, while the BOJ may keep policy loose to sustain inflation. U.S labor cost data is likely to reinforce the tight job market is fueling wage gains and inflation pressures. Global PMI data will help gauge how much rate hikes are dampening activity. We see major central banks holding policy tight even as activity slows.

Directional views

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

Underweight
Neutral
Overweight
● Previous view

	Asset	Strategic	Tactical	Commentary
Equities	Developed	+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. 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.
	Emerging	Neutral	+1	Strategically, we are neutral as we don't see significant earnings growth or higher compensation for risk. We are overweight tactically on brighter growth trends in EM over DM, still appealing valuations and EM rate cycles nearing their peaks.
Developed market government bonds	Nominal	-2	-1	Higher-for-longer policy rates have bolstered the case for short-dated government debt in portfolios on both tactical and strategic horizons. We stay underweight nominal long-dated government bonds on both horizons as we expect investors to demand more compensation for the risk of holding them. Tactically, we are neutral on euro area and UK long-term bonds because higher yields better reflect our view.
	Inflation-linked	+3	Neutral	Our strategic views are maximum overweight DM inflation-linked bonds where we see higher inflation persisting – but we have trimmed our tactical view to neutral on current market pricing in the euro area.
Public credit and emerging market debt	Investment grade	Neutral	Neutral	We are neutral investment grade credit due to tightening credit and financial conditions but see it playing an important income role in portfolios on both horizons.
	High yield	Neutral	-1	Strategically, we are neutral high yield as we see the asset class as more vulnerable to recession risks. We're tactically underweight. Spreads don't fully compensate for slower growth and tighter credit conditions we expect.
	EM debt	Neutral	+1	Strategically, we're neutral and see more attractive income opportunities elsewhere. Tactically, we're overweight local-currency EM debt. We see it as more resilient with EM central banks closer to cutting rates than DM counterparts.
Private markets	Income	+1	–	We are strategically overweight private markets income. For investors with a long-term view, we see opportunities in private credit as private lenders help fill a void left by a bank pullback.
	Growth	-1	–	Even in our underweight to growth private markets, we see areas like infrastructure equity as a relative bright spot.

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, July 2023

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

Asset	View	Commentary
Equities		
Developed markets		
United States	-1	We are underweight the broad market – still our largest portfolio allocation. We don't think earnings expectations reflect the macro damage we expect. We recognize momentum is strong near term.
Europe	-1	We are underweight. The European Central Bank keeps tightening in a slowdown and the support to growth from lower energy prices is fading.
UK	Neutral	We are neutral. We find that attractive valuations better reflect the weak growth outlook and the Bank of England's sharp rate hikes to deal with sticky inflation.
Japan	Neutral	We are neutral. Bank of Japan policy is still easy, shareholder-friendly reforms are taking root and negative real rates support equities.
Pacific ex-Japan	Neutral	We are neutral. China's restart is losing steam and we don't see valuations compelling enough to turn overweight.
DM AI mega force	+1	We are overweight. We see a multi-country and multi-sector AI-centered investment cycle unfolding set to support revenues and margins.
Emerging markets		
China	+1	We are overweight. We see brighter relative growth trends in EM over DM, valuations remain appealing and EM rates cycles are nearing peaks.
Fixed Income		
Short U.S. Treasuries	+1	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
Long U.S. Treasuries	-1	We are underweight. We see long-term yields moving up further as investors demand greater term premium.
U.S. inflation-linked bonds	+1	We are overweight and prefer the U.S. over the euro area. We see market pricing underestimating sticky inflation.
Euro area inflation-linked bonds	-1	We prefer the U.S. over the euro area. Markets are pricing higher inflation than in the U.S., even as the European Central Bank has signaled more interest rate hikes ahead.
Euro area govt bonds	Neutral	We are neutral. Market pricing better reflects rates staying higher for longer. We see risk of wider peripheral bond spreads due to tighter financial conditions.
UK gilts	Neutral	We are neutral. We find gilt yields better reflect our expectations for the macro outlook and Bank of England policy.
Japanese govt bonds	-1	We are underweight. We see upside risks to yields from the Bank of Japan winding down its ultra-loose policy.
China govt bonds	Neutral	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.
Global IG credit	Neutral	We are neutral on tighter credit and financial conditions. We prefer Europe's more attractive valuations over the U.S.
U.S. agency MBS	+1	We're overweight. We see agency MBS as a high-quality exposure within diversified bond allocations.
Global high yield	-1	We are underweight. Spreads do not fully compensate for slower growth and tighter credit conditions we anticipate.
Asia credit	Neutral	We are neutral. We don't find valuations compelling enough to turn more positive.
Emerging hard currency	Neutral	We are neutral. Better fundamentals and undemanding valuations are offset by the risk from rising U.S. yields.
Emerging local currency	+1	We are overweight. EM central banks are closer to cutting rates than DM counterparts.

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