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Weekly commentary

BlackRock

January 24, 2022

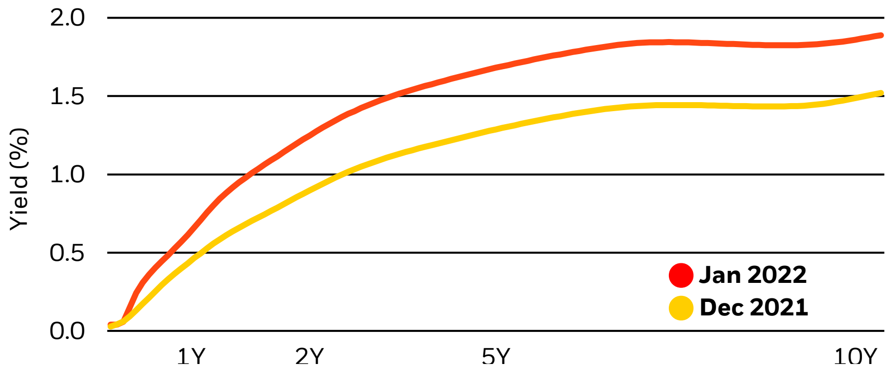
Trimming our Treasury underweight

- We reduce our underweight of U.S. Treasuries after the surprising yield surge this month while still seeing the direction of travel for yields as higher.
- Bond yields hit highs and stocks fell last week. We view the yield surge as a reallocation away from government bonds and not necessarily bad for equities.
- The Fed is meeting this week amid market expectations of aggressive tightening later this year. More than one-fifth of S&P 500 companies is reporting results.

We see the sharp rise in government bond yields this year as consistent with a fundamental asset reallocation driven by investors wanting greater compensation for the risk of holding government bonds. The swiftness of these moves is an example of a market primed to overshoot amid confusion over the macro backdrop, as flagged in our 2022 Global Outlook. We slightly reduce our tactical underweight on U.S. Treasuries as a result, while keeping our strategic underweight unchanged.

Too much, too soon?

Shift in the U.S. yield curve, Dec 2021-Jan 2022



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and not subject to fees. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, January 2022. Notes: The chart shows the number of 25 basis point rate to the end of 2024 across selected DM economies priced in currently vs. the number that were priced in November 2021. The hikes are calculated by comparing the average forward rate priced by the market in 2024 and comparing it to the current rate. We use the Secured Overnight Financing Rate in the U.S. and overnight index swaps for the rest.

Bonds have had a rough start to 2022 – extending last year's unusually poor run. Yields are up sharply in the last month, as the chart shows. The short-end has surged because of a sharp pulling forward of policy rate hikes. Markets have rushed to price in faster and more aggressive Fed actions than we think is warranted. The rise in 10-year yields has largely been driven by a resurgence of the term premium, or the extra compensation investors demand for the risk of holding government bonds at still historically low yield levels. We have long had an underweight in U.S. Treasuries, so the recent market moves are playing out as we expected via a higher term premium – just much faster. Our base case remains that yields are headed higher on a one-year horizon, yet a short-term reversal has already started to unfold. On a strategic or long-term horizon, we still view the outlook for nominal government bonds as challenging and maintain our large underweight.

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What's striking is the speed of the yield spike. The Fed has effectively abandoned its prior guidance by suggesting it's ready to start raising rates before achieving its "broad and inclusive" employment mandate. By doing so, it may have added to the confusion about the expected path of rates. Markets have quickly shifted their short-term expectations to include earlier and more rate hikes this year. The hawkish mood has spread to longer-term yields and to markets such as the euro area.

We trimmed risk heading into 2022 because we thought potential confusion over the macro backdrop could become a source of market stress. But cutting through the confusion – one of our 2022 Global outlook themes – is about recognizing that what matters is the cumulative rate hikes priced in over coming years, not their timing. That hasn't changed and believe that's right. How to cut through the confusion? We believe the key to making sense of the current environment is to recognize the cause of inflation: supply constraints. This marks a profound change from the decades-long dominance of demand drivers. We are in *A world shaped by supply*, where monetary policy cannot stabilize both inflation and growth: it has to choose between them. Central banks will be forced to live with more inflation, in our view, given the cost to growth of pushing down inflation. Understanding this shift in the economic landscape helps put the Fed's pivot in context: it is taking its foot off the gas by starting to remove emergency stimulus – but this is a far cry from slamming on the policy brakes. We expect the transition to a more sustainable world to drive supply-triggered inflation far beyond the current economic restart. This is why we still see a historically muted policy response to inflation.

Our bottom line: Given the speed of the Fed repricing, bond markets may have gotten ahead of themselves in the short term. We reduce our tactical underweight to U.S. Treasuries as a result. But the backdrop for Treasuries remains negative as we see a further resurgence of the term premium pushing yields higher, especially as the Fed prepares to shrink its balance sheet. We don't see this as necessarily bad news for equities. This year's stock selloff hides huge shifts under the hood, with tech shares falling and many cyclicals eking out gains. We believe the narrative of "rates up, tech down" is too simplistic given the drivers behind the long-end bond selloff and the broadly unchanged, still-low sum total of expected rate hikes. Indeed, we believe fading Omicron fears have contributed to the tech selloff. We favor a barbell approach in our sector views. We like cyclicals as the powerful restart rolls on, and beyond a tactical horizon we still favor solid tech and healthcare stocks because we see them as beneficiaries of structural trends like digitalization and the transition to a net-zero world.

Market backdrop

The surge in long-term yields is part of what we see as a broader reallocation driven by the need for greater compensation for the risk of holding fixed income. That ultimately shouldn't hurt risk assets, in our view. It's early days still in the earnings season, but more than 75% of the 11% of the S&P 500 companies have beaten estimates. And growth expectations are being revised up as Omicron waves abate. We see inflation settling at a level higher than pre-COVID.

Assets in review

Selected asset performance, 12-month 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 January 20, 2022. Notes: The two ends of the bars show the lowest and highest returns at any point over the last 12-months and the dots represent current 12-month 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, in descending order: spot Brent crude, MSCI Europe Index, MSCI USA Index, ICE U.S. Dollar Index (DXY), Bank of America Merrill Lynch Global High Yield Index, spot gold, J.P. Morgan EMBI Index, Refinitiv Datastream Italy 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index, Refinitiv Datastream Germany 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index and MSCI Emerging Markets Index.

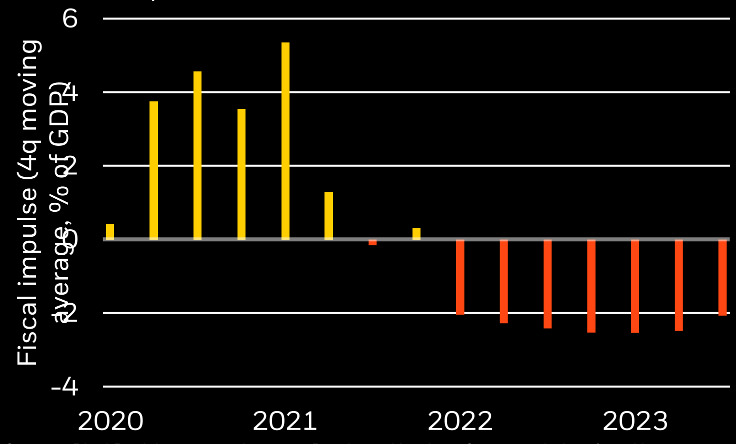
Macro insights

Governments provided people and businesses with critical income support as a bridge through the pandemic shutdowns. Think of the stimulus checks and unemployment benefit top-ups in the U.S. This has had a positive impact on economic activity. The size of this effect – the so-called fiscal impulse - has been greatest in the U.S. and cushioned the hit to the economy from the pandemic in 2020-2021, as the yellow bars in the chart show.

All that is changing now. Economies have restarted, so governments have scaled back fiscal support. This will act as a material drag on growth in 2022 and beyond, as the chart's red bars show. Will the U.S. economy be able to weather this? We think so. First, the economic restart is driven by the lifting of restrictions and does not rely on stimulus measures. Second, households have built up excess savings. Even if they spend only a fraction of it, they will provide a material boost to consumption. Third, the potential passing of the Build Back Better Bill heralds more government spending that would reduce the drag. See our macro insights hub.

Government scaling back support

U.S. fiscal impact, 2020-2023



Sources: BlackRock Investment Institute, Brookings Hutchins Center, with data from Haver Analytics, January 2022. Note: The chart shows estimates of how much U.S. fiscal spending (from federal, state and local sources) contributes to GDP growth. A positive contribution implies a boost to growth. Estimates are published by the Brookings Hutchins Center, and the bars show the four-quarter moving average of quarterly growth impulses (at an annual rate).

Investment themes

1 Living with inflation

- We expect inflation to be persistent and settle above pre-COVID levels. We expect central banks to kick off rate hikes but remain more tolerant of price pressures, keeping real interest rates historically low and supportive of risk assets.
- Inflation is being driven by the unusual restart dynamics of extraordinary demand bumping up against supply bottlenecks. We expect many COVID-related supply-demand imbalances to resolve over the year.
- The policy response to rising inflation isn't uniform. The Fed and the ECB are more tolerant of inflation, even as the Fed has started to warn of inflation risks.
- Other developed market (DM) central banks have signaled policy rate paths with steeper initial increases, and many of their emerging market (EM) counterparts have already lifted off.
- The Fed has achieved its new inflation goal to make up for past misses and sees full employment being reached this year. This is the justification for the three rate hikes it has suggested for 2022. This is more than we expected, but we believe the total sum of hikes is unchanged and historically muted – and more important to markets.
- The Fed has sped up its tapering of bond purchases and has indicated it may start to trim its bond portfolio earlier than expected by letting bonds run off when they mature.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- A unique mix of events - the restart of economic activity, virus strains, supply-driven inflation and new central bank frameworks - could cause markets and policymakers to misread the current surge in inflation.
- We keep the big picture in mind: We see the restart rolling on, inflation meeting a muted central bank response, and real rates remaining historically low.
- We do see increasing risks around this base case: Central banks could revert to their old policy response, and growth could surprise on the upside or disappoint.
- There's also a risk markets misread China's policy. The country has emphasized social objectives and quality growth over quantity in regulatory crackdowns that have spooked some investors. Yet policymakers can no longer ignore the growth slowdown, and we expect incremental loosening across three pillars - monetary, fiscal and regulatory.
- **Investment implication:** We have trimmed risk-taking amid an unusually wide range of outcomes.

3 Navigating 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.
- Sustainability cuts across multiple dimensions: the outlook for inflation, geopolitics and policy. The green transition comes with costs and higher inflation, yet the economic outlook is unambiguously brighter than a scenario of no climate action or a disorderly transition. Both would generate lower growth and higher inflation, in our view.
- Risks around a disorderly transition are high – particularly if execution fails to match governments' ambitions to cut emissions.
- We favor 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**: We favor DM equities over EM as we see them as better positioned in the green transition.

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Week ahead

Jan. 24	Global flash purchasing managers' indexes
Jan. 25-26	U.S. Federal Open Market Committee (FOMC) meeting
Jan. 27	U.S. GDP, Japan inflation data
Jan. 28	U.S PCE inflation and employment cost data

No policy change is expected at this week's FOMC meeting, yet the meeting comes amid heightened market expectations of a sharp Fed rate hiking cycle starting as soon as March. The focus will be on what is actually driving Fed policy now that it has walked back on its previous guidance that meeting its "broad and inclusive" employment goal was a pre-cursor to lift off. Corporate earnings season sees about two-thirds of the S&P 500 – including big tech – reporting results the next two weeks.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, January 2022

Underweight **Neutral** **Overweight**

Change in view
Previous New

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight on equities on a strategic horizon. We see the combination of low real rates, strong growth and reasonable valuations as favourable for the asset class. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we are overweight equities amid solid economic fundamentals and historically low real rates.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich, and we prefer to take risk in equities instead. On a tactical horizon, we are neutral credit given low spreads across sectors and prefer EM local markets to high yield.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Within the underweight on nominal DM government bonds, we prefer shorter-dated over long-dated maturities. Rising debt levels may eventually pose risks to the low rate regime. We prefer inflation-linked bonds. Tactically, we keep our significant U.S. Treasuries underweight on expectations of rising yields into the Fed's taper and rate kick-off. We prefer inflation-linked bonds for interest rate exposure and as a portfolio diversifier.
Private markets	Neutral	—	We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.

Note: Views are from a U.S. dollar perspective, January 2022. 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.

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Granular views

Six to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, January 2022

Underweight **Neutral** **Overweight**

Change in view

Previous New

	Asset	Underweight	Overweight	
Equities	**Developed markets**			We are overweight developed market equities. We see still solid growth and low real yields supporting valuations. We prefer to diversify our exposure.
	United States			We are overweight U.S. equities on still strong earnings momentum. We do not see gradual policy normalization posing significant headwinds.
	Europe			We stay modestly overweight European equities given attractive valuations. We believe the rise in Covid infections may stall but not derail the restart
	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
	Japan			We have a small overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
	China			We stay moderately positive on Chinese equities as we see a shift to a slightly easier policy. We expect the regulatory clampdown to last but not intensify.
	Emerging markets			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
aFixed Income	U.S. Treasuries			We reduce our underweight U.S. Treasuries given the yield surge so far the year. Over a longer horizon, we see higher yields as investors demand a higher premium for holding governments bonds
	Treasury Inflation-Protected Securities			We stay overweight U.S. TIPS as we expect inflation to be persistent and settle at a higher level than pre-Covid. We prefer TIPS for interest rate exposure and diversifiers.
	European government bonds			We keep our underweight on European government bonds. We see yields heading higher. Current market pricing points to no substantive change in monetary policy for several years.
	UK gilts			We are neutral UK Gilts. We see UK policy rates rising before DM peers, yet believe market expectations of the subsequent pace are overdone amid constrained supply.
	China government bonds			We are overweight Chinese government bonds. Potentially easier monetary policy alongside the relative stability of interest rates and potential income brighten their appeal.
	Global investment grade			We stay underweight investment grade credit. We see little room for further yield spread compression and remain concerned about interest rate risk.
	Global high yield			We are neutral high yield. We do not see compression in high yield spreads yet still find the carry attractive. We prefer to take risk in equities.
	Emerging market – hard currency			We are neutral hard-currency EM debt. We expect it to gain support from the vaccine-led global restart and more predictable U.S. trade policies.
	Emerging market – local currency			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.
	Asia fixed income			We stay overweight Asia fixed income. We find valuations in China compelling relative to risks. Outside China, we like Asian sovereigns and credit for income and carry.

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