Weekly commentary

BlackRock

January 31, 2022

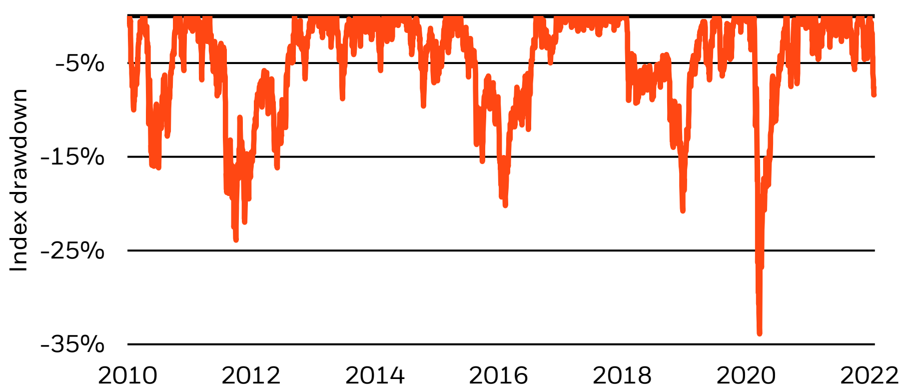
Keeping our modest equity overweight

- We stick with our modest equities overweight but are not buying the recent dip yet. The main reason: confusion over the supply-driven macro environment.
- Stocks fell further as the Fed flagged a likely rate hike in March and suggested it could front-load rate hikes even more than previously indicated.
- U.S. jobs data this week will show Omicron's impact on the restart – but is unlikely to dissuade the Fed from kicking off rate hikes in March.

Coming into 2022, we dialed down overall risk to have a modest overweight to equities on concerns about confusion over the macro environment. We don't see a need to reduce risk further: the confusion has materialized. The roughly 10% drop in U.S. equities – against our unchanged view of fundamentals – makes them more attractive on the surface. Yet accounting for higher expected interest rates, we don't think equities have dropped enough for a valuation-driven upgrade.

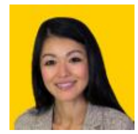
Putting the equity selloff in context

Global equities rolling one-year price drawdown, 2010-2022



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, Jan. 28, 2022. Notes: The chart shows the price fall from the maximum level of the MSCI All-Country World Index over the previous one-year period.

Context is crucial. The equity retreat is far from magnitudes that warrant a wholescale reassessment of our views. The chart above shows the major drawdowns – calculated as the peak-to-trough moves over a rolling one-year period – for the MSCI All-Country World index. The takeaway: This pull-back is modest compared with some of the drops seen over the past decade. It also comes after a particularly strong run for risk assets. We believe the drawdown is consistent with our expectation for confusion and heightened volatility. The market has front-loaded pricing of Fed rate hikes over the next two years. Yet importantly, the sum total of Fed rate hikes hasn't changed – only the timing. That's why we think the move in equities cannot be explained by this repricing alone. The U.S. equity risk premium – our preferred valuation gauge as it takes into account both earnings expectations and the interest rate environment – has moved up. It reflects confusion about whether the Fed will go further than priced and deliberately destroy demand to get inflation down, as well as worries on the geopolitical front.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We hold to our view that the unusual market regime we outlined in our 2022 Global Outlook will deliver a second successive year of equity gains and bond losses. The underlying drivers are unchanged. Yet we are also seeing the confusion we had flagged in action, the risk that central banks and markets might misinterpret the unusual restart and supply-driven inflation. The confusion is playing out via a swift market repricing of Fed policy expectations and surging short-term yields.

What might prompt us to change our modest overweight to equities? For an upgrade, we would need to see a deeper retreat or the Fed acknowledging that it will live with some inflation to keep the restart going in a trade-off of its objectives. For a downgrade, we would look to see if the Fed prioritizes fighting inflation over activity – with or without acknowledging a trade-off between its objectives. We got a hint of a tougher inflation stance last week but would need to see more evidence of a more forceful shift in tactics on inflation.

We see uncertainty lingering for a few reasons. First, we think policy confusion can persist. The Fed is rightly intent on normalizing policy quickly. The restart does not need stimulus, so the Fed should take its foot off the accelerator. Our worry: The Fed likens the current normalization to a previous episode in 2015. We think such logic could lead the Fed to overtighten policy. This is a restart, not a typical recovery. The restart will quickly slow down on its own. Inflation is driven by supply constraints following a huge shift in demand during the pandemic, not an overheating economy – so the traditional policy playbook does not apply. We think the Fed will eventually back off but are prepared for a bumpy ride in markets. Second, geopolitical risks – while typically not long-lasting market events – could weigh on investor sentiment, including the stand-off over Ukraine and the Iran nuclear deal. Third, equity valuations by our measure are only modestly cheaper and reflect some of the confusion we describe. With market attention on the Fed repricing, companies beating estimates have not yet been rewarded this earnings season. Yet we think fundamentals will prevail, and that's one reason why we are not downgrading our modest equities overweight.

Our bottom line: We maintain our modest equities overweight, with a preference for developed markets and China. We prefer balanced exposures to beneficiaries of long-term trends such as tech and healthcare on the one hand and cyclicals on the other. We need to see a deeper equity selloff and more clarity on near-term uncertainties to add to our equities overweight.

Market backdrop

Fed Chair Jerome Powell flagged a likely rate hike in March and suggested the Fed could front-load rate hikes even more than previously indicated. Stocks extended their volatile run into the last week of the month, with U.S. tech leading losses. U.S. Treasury yields are also sharply higher across the board this month. The short-end has surged because of a sharp pulling forward of policy rate hikes, while we see the 10-year yield driven more by a resurgence of the term premium.

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 28, 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 Germany 10-year benchmark government bond index, Refinitiv Datastream Italy 10-year benchmark government bond index, Refinitiv Datastream U.S. 10-year benchmark government bond index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI Emerging Markets Index.

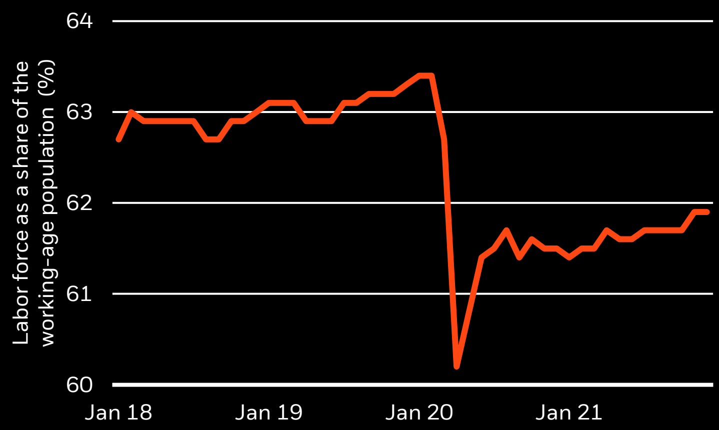
Macro insights

The Federal Reserve last week emphasized it wanted to normalize monetary policy – so it is neither accommodative nor restrictive – as quickly as possible. This marks a departure from its guidance last year, but makes sense to us. The restart is self-sustaining and doesn't need stimulus. Importantly, returning to neutral more quickly does not mean a change in cumulative rate hikes.

Chair Jerome Powell's comparison to the 2015 normalization worries us, however. We think that following such a logic could result in overtightening policy. We are experiencing a unique restart of economic activity, rather than a typical recovery. The restart will quickly slow down on its own - and current inflation is driven by a mismatch of supply and demand, not the overheating of the economy. Adding to the confusion: The Fed declared it had achieved its full employment mandate even with labor force participation – Powell's previous focus – below pre-Covid levels, as the chart shows. This reinforces the risk of the Fed overtightening policy. See our macro insights hub.

Labor force participation still healing

U.S. labor force participation, 2018-2021



Sources: BlackRock Investment Institute, U.S. Bureau of Economic Analysis, with data from Haver Analytics, January 2022. Note: The chart shows the U.S. labor force participation rate, measured by the share of the working-age population (aged 16+) who are in the labor force – either in work, or actively looking for work.

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 supply-demand imbalances to resolve over the year.
- The policy response to rising inflation isn't uniform. Developed market (DM) central banks have already demonstrated they are more tolerant of inflation, even as several are gearing up to kick off rate hikes with steeper initial increases. 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 it has met its full employment mandate. This is the justification for kicking off rate hikes soon, likely in March. Still, we believe the total sum of hikes is unchanged and historically muted – and that's more important to markets.
- The Fed has sped up its tapering of bond purchases and has indicated it may start to trim its balance sheet 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.

Week ahead

Feb. 1	Euro area unemployment rate	**Feb. 3**	ECB, BoE monetary policy meetings
Feb. 2	Euro area flash inflation	**Feb. 4**	U.S. employment report

U.S. jobs data this week will shed some light on the impact of Omicron on the restart but is unlikely to dissuade the Fed from kicking off rate hikes at its March meeting. We are also focused on the Bank of England. The BoE may follow its December rate hike with another one and could start to unwind its balance sheet. Markets do not expect any change in policy from the European Central Bank, but the media briefing could shed light on future moves.

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 trim our significant U.S. Treasuries underweight – we see the direction of travel for yields as higher but think the move is overdone for now . 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.

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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