Weekly commentary

BlackRock

March 14, 2022

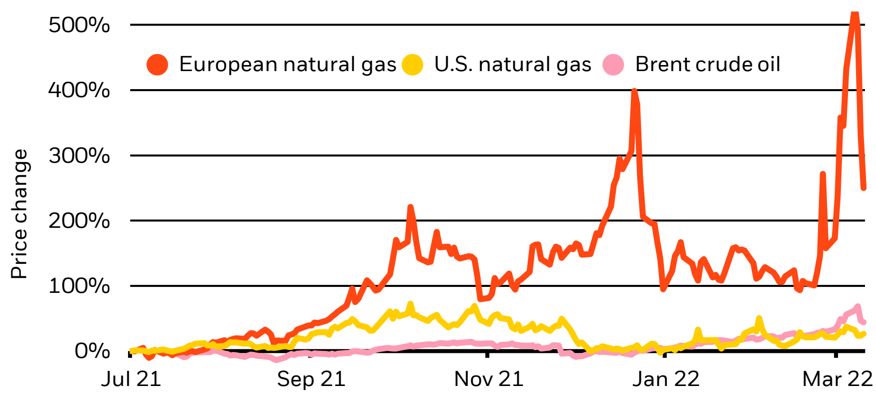
Ukraine war to cut growth, up inflation

- We see the Ukraine war reducing global growth, increasing inflation and putting central banks in a bind. We prefer developed stocks in the inflationary backdrop.
- Stocks led by European equities bounced from 2022 lows last week, as oil prices came off highs. The European Central Bank accelerated policy normalization.
- The Fed is set to raise its policy rate by 0.25% this week – the first hike since the pandemic started. We still see a historically muted response to inflation.

The war in Ukraine has already caused a terrible human toll. We see it extracting a heavy economic price as well, mostly via higher energy costs. This is a major supply shock layered onto an existing one, and we see it resulting in higher inflation and lower growth, especially in the euro area. This puts central banks in a bind: Trying to contain inflation will be more costly, and they can't cushion the growth shock. We prefer developed equities in this inflationary environment.

Energy shock

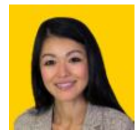
U.S. and European energy prices, 2021-2022



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, March 2022. The lines show the changes in price of different commodities since July 1, 2021. European natural gas price based on European Energy Derivatives Exchange futures, U.S. based on MYM-Henry Hub Gas futures price. Oil price based on ICE-Brent crude futures.

The Ukraine war has caused a spike in energy prices, putting a damper on growth and exacerbating supply-driven inflation. Europe is most exposed. Natural gas prices have surged beyond 2021 peaks, as the red line in the chart shows, before reversing a bit last week. The big difference with 2021: High energy prices are now the *cause* of a downdraft in growth, whereas they were the *outcome* of strong growth then. The culprit is Europe's reliance on Russian gas in an already tight market. The powerful economic restart from the Covid-19 shock in 2021 had already exposed mismatches in the region's energy supply and demand. This was aggravated by a mix of geopolitical factors and weather-related supply disruptions just as European inventories were low. The recent surge in European energy prices has pushed the region's energy burden as a percentage of GDP to above levels reached in the early 1970s, we calculate, whereas the U.S. is still well below it. This is why we think the impact of the current energy shock for Europe could be on par with previous severe episodes such as the 1973 oil embargo.

Alex Brazier
Deputy Head – BlackRock Investment Institute



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Higher energy prices are a material, global shock. Europe is facing a large, stagflationary shock, in our view. Analysts are ratcheting down their growth forecasts and upping their inflation projections. This is not over, and we believe the European Central Bank (ECB) growth forecasts understate the shock's impact on growth. The U.S. is in a better spot, in our view. The shock is less than previous energy crises. The U.S. also has a larger growth cushion thanks to the strong restart's momentum – even if some of European weakness is bound to spill over.

How will policymakers respond to the poisonous combination of slowing growth and rising inflation? Central banks have to normalize policy as the economy no longer needs stimulus, we believe, so policy rates are headed higher. The ECB last week said it would phase out asset purchases and left the door open for a rate increase this year – the first in more than a decade. The U.S. Federal Reserve this week is expected to announce its first rate hike since the Covid shock, while the Bank of England and a slew of emerging market central banks are set to hold rates or raise them. We still see a historically muted cumulative response to inflation; more aggressive tightening would come at too high a cost to growth and employment. Central banks will be forced to live with inflation. But it's tough to see central banks coming to the rescue to halt a growth slowdown in the inflationary environment. Our conclusion: central banks are less likely to shape macro outcomes going forward. That leaves fiscal support. The war has raised the prospect of fiscal stimulus to achieve energy security and up defense outlays, but we see this taking time.

The imminent hit to growth has reduced the risk that central banks slam the brakes to contain inflation. So what *are* the risks? In the short run, escalation of the war and more energy supply shocks are key catalysts for more risk-off market moves. We see a risk of inflation expectations becoming unanchored in the medium term, causing central banks to raise rates sharply. Energy prices are now *driving* growth, rather than being the result of it. This raises the specter of stagflation– something that was not in play before due to the economy's strong growth momentum.

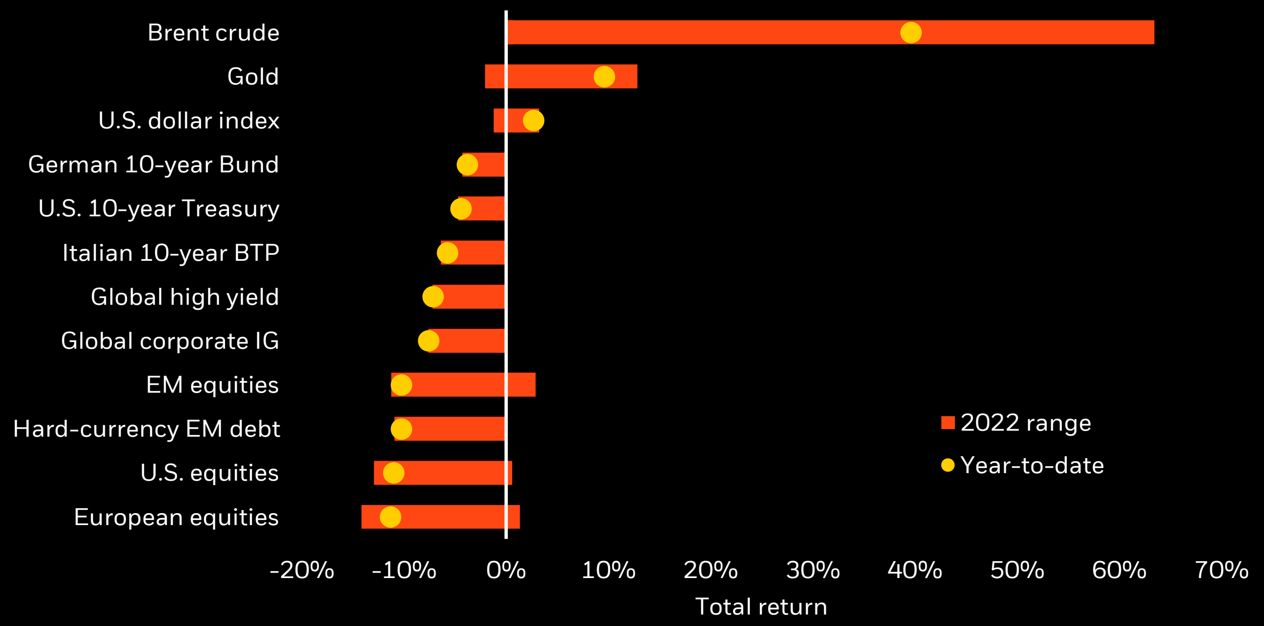
What does this mean for investments? We prefer to take risk in DM equities against the inflationary backdrop of negative real bond yields. We expect the global energy shock to hurt corporate earnings, especially in Europe. Recent market declines reflected this, we believe, and the region's stocks are highly geared toward global growth. We stay underweight government bonds. They are losing their diversification benefits, and we see investors demanding greater compensation for holding them amid higher inflation and larger debt loads. Within the asset class, we prefer short-dated and inflation-linked bonds.

Market backdrop

Crude oil prices shot up to 14-year highs on supply concerns but then suffered their biggest one-day decline in almost two years. Equities followed suit, rebounding from plumbing new 2022 lows earlier in the week. The ECB said it would phase out asset purchases in the third quarter and left the door open for a rate increase this year. Peripheral bond spreads widened.

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 March 10, 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.

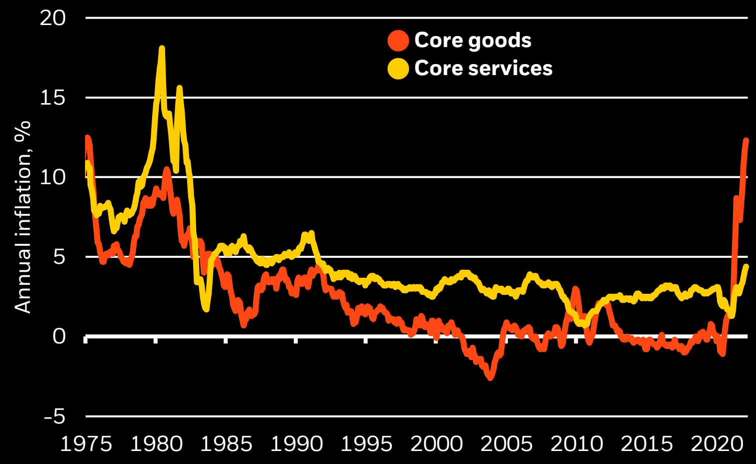
Macro insights

Inflation is at historical highs because of a supply shock triggered by the Covid-19 pandemic. The lockdowns and restrictions on activity led to a massive shift in consumer spending away from services, especially contact-intense ones, and toward goods. This sudden increase in demand for goods created supply bottlenecks that pushed up prices. The increase in good prices is far outpacing services inflation, as the chart shows.

The reopening of economies will alleviate some of the pressure, in our view. Case in point: Consumer price index data for the U.S. last week revealed a slight easing in goods inflation versus the previous month, even if the year-on-year rate is still edging up. That said, inflation is likely to stay elevated for some time for two main reasons. First, the Ukraine war and the West's move away from Russian energy is pushing up energy prices – as well as commodities and food prices. Second, this inflation is due to supply shocks, not excess demand, so central banks cannot do much about it. We expect them to live with inflation. See our macro insights.

Spending shift drives inflation

U.S. core goods and services CPI inflation, 1975-2022



Sources: BlackRock Investment Institute, U.S. Bureau of Labor Statistics, with data from Haver Analytics, March 2022. Notes: The orange and yellow lines show core goods and core services CPI inflation respectively, measured by the year-on-year percent change in prices

Investment themes

1 Living with inflation

- We expect central banks to carry on with normalizing policy. We see a reduced risk of them slamming on the brakes to deal with supply-driven inflation. Politically, it's easier to blame inflation on the Ukraine war and argue that monetary policy can do little about it, in our view.
- This means central banks are unlikely to come to the rescue to halt a growth slowdown by cutting rates. In addition, the risk of inflation expectations becoming unanchored has increased as inflation becomes more persistent.
- We believe the cumulative response to rising inflation will be historically muted. DM central banks have already demonstrated they are more tolerant of inflation.
- The Fed is poised to start hiking rates this week for the first time since the pandemic hit. The European Central Bank last week struck a hawkish tone, leaving the door open for a rate increase later this year. We expect it to adopt a flexible stance in practice, given the material hit to growth from higher energy prices.
- **Investment implication**: We prefer equities over fixed income and remain overweight inflation-linked bonds.

2 Cutting through confusion

- We had thought the 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 saw the confusion play out with the aggressively hawkish repricing in markets at start the year.
- The Russia-Ukraine conflict has aggravated inflation pressures and has put central banks in a bind.Trying to contain inflation will be more costly to growth and employment, and they can't cushion the growth shock.
- The sum total of expected rate hikes hasn't changed, even as markets have cooled expectations of higher rates in the near term.
- **Investment implication:** We have tweaked our risk exposure to favor equities at the expense of credit.

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

March 15	China industrial output and retail sales; UK unemployment data	**March 17**	UK, Indonesia and Turkey rate decisions
March 16	Fed monetary policy meeting; Brazil rate decision	**March 18**	Russia rate decision

The U.S. Federal Reserve is expected to raise its policy rate for the first time since the Covid shock. The Bank of England (BoE) is set to announce its third hike, and a slew of emerging market central banks are set to hold rates or raise them. Both the Fed and BoE are keen to normalize policy rates back to pre-Covid settings. We don't expect them to go beyond that to try to squash high inflation as the costs to growth and employment would be too high. We see central banks living with inflation.

Directional views

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

Underweight **Neutral** **Overweight**

Change in view
Previous New

Asset	**Strategic view**	**Tactical view**	
Equities	+2	+1	We added to our strategic equities overweight in February. The early 2022 selloff created an opportunity for long-term investors as we see the combination of low real rates, strong growth and reasonable valuations as favorable 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	-1	We are underweight credit on a strategic and tactical basis against a backdrop of rising long-end rates and high valuations. We prefer to take risk in equities instead. Tactically, we remain overweight local-currency EM debt.
Govt bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio diversifiers with yields near lower bounds. We see the long-term outlook for the asset class challenged by rising term premium and our expectation of higher medium-term inflation than markets are pricing. We prefer inflation-linked bonds. Tactically, we recently reduced our underweight to U.S. Treasuries – 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. 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, March 2022

Underweight | Neutral | Overweight

Change in view: Previous → New

	Asset	Underweight	Overweight	
Equities	**Developed markets**		■■	We increased our overweight on developed market equities last month after this year's pullback. The market's view of rate hikes is overly hawkish, in our view. Solid growth and low real yields support more attractive valuations.
Equities	United States		■■	We raised our overweight in U.S. equities last month due to still strong earnings momentum. We do not see policy normalization posing significant headwinds.
Equities	Europe		■■	We increased our overweight in European equities last month given attractive valuations. We believe the market's view of euro area rate hikes is particularly excessive.
Equities	UK			We are neutral UK equities. We see the market as fairly valued and prefer European equities.
Equities	Japan		■	We are overweight in Japanese equities. We see a global cyclical rebound boosting earnings growth following underperformance in 2021.
Equities	**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.
Equities	**Emerging markets**			We are neutral EM equities and prefer DM equities, given more challenged restart dynamics and tighter policies in EM.
Equities	Asia ex-Japan			We are neutral Asia ex-Japan equities. We prefer more targeted exposure to China relative to the broad region.
Fixed Income	U.S. Treasuries	■		We recently reduced our underweight to U.S. Treasuries given the yield surge so far this year. Over a longer horizon, we see higher yields as investors demand a higher premium for holding governments bonds.
Fixed Income	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.
Fixed Income	European government bonds	■		We are underweight on government bonds. We see yields heading higher even as market pricing has adjusted sharply to price in an end of negative rates and beyond.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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.
Fixed Income	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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